"Finally!...This book will benefit dyed-in-the-wool value investors and newcomers alike. Highly Recommended!"

JOHN MIHALJEVIC
The Manual of Ideas

VALUE INVESTING

A Value Investor's Journey Through The Unknown...

J. Lukas Neely
Founder of EndlessRiseInvestor.com

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Value Investing:
A Value Investor's Journey
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By J. Lukas Neely

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Your Free Gift

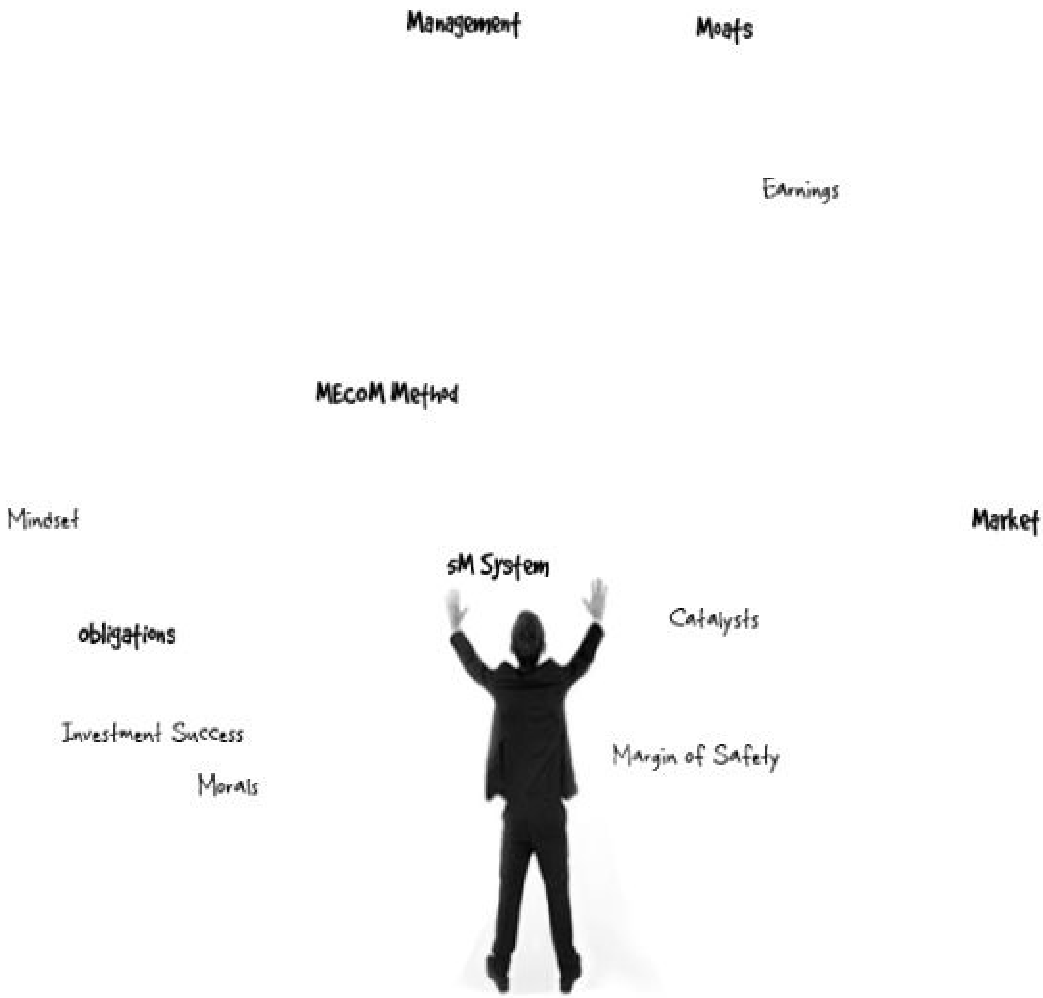
As a way of saying *thanks* for your purchase, I'm offering a free investing *mindmap and blueprint* that's exclusive to my readers.

Making money investing in the stock market offers a rare opportunity for ANYONE to generate and grow wealth into the future. But in order to reap the benefits of investing it requires the right type of mindset and processes. That's why I created the *Ultimate Investor Blueprint.*

This Blueprint includes the *5M™ Mental Model* (detailed in this book), *advanced video tutorial*, a *Mindmap* of the process, as well as *checklists*, and *much more*. It encompasses everything an investor would need on their journey to investing success, whether you're a seasoned professional or newbie investor. You can download this free blueprint by going here.

https://uibfreegift.endlessriseinvestor.com/blueprint

See A lot…You See Little,



See Little…You See A Lot!

Contents

FAQ – DOUBTERS READ THIS

Is investing right for you? Chances are good that it is. Here are some of the the most common doubts and fears that people have before taking the leap and joining the Endless Rise Investors:

Do I have to be a risk-taker? Do I have to take time out of my day?

Erroneous on all counts. I always wanted to say that.

From developing the proper mindset like the super investors of our time to easily valuing all types of businesses. How does a person spend just 60 minutes per month on their investing, yet still produce out-sized investment returns? How to know what kind of businesses to invest in and which businesses to avoid to protect your wealth? It's all here.

I feel like my time has passed. Do I need to be in my twenties and single to get involved in investing now?

Not at all. This book is for anyone who is sick of deferring money making decisions to so-called "professionals" and giving their hard earned money to managers that make money whether you realize returns or not. If you're sick of the standard menu of options and prepared to enter a world of infinite options and opportunity, this book is for you

I just want more time. Do I have to spend hours doing this?

No. It's an option. However, the objective of the 5M™ Mental Model is to create freedom of time by arming you with an easy to follow mental model focused on the most important factors to investment success. Once you have a grasp of the 5M™ Mental Model you will be able to determine high quality investment opportunities easily and efficiently.

I don't have much money. Do I need to be born rich?

Absolutely not. Although my parents worked very hard, I was never born into a life of luxury; I'm no Vanderbilt or Rockefeller or Walton, and you needn't be either.

Do I need to be an Ivy League or business school graduate?

Not one bit. Many of the world’s top investors didn't go to the Yale's of the world (although there’s nothing wrong with the Yale’s of the world). There are too many unrecognized benefits to not coming out of one. Top academic institutions are great. I believe they do more good than bad, however many of these students are funneled into these high-stress, high-income, 80 hour week jobs. For many of them, that's 20-30 years of soul-crushing, unfulfilling work that they believe is the only path.

How do I know? I've seen it first hand. And I've seen the destruction it can cause to a person and the financial system as a whole. This book helps to reverse that.

5M™ Mental Model and MECOM™ Method…it sounds a little cheesy and gimmicky…?

Ha. I thought the same thing. In creating a philosophy and method for investing success, I wanted to create something that would stick in the minds of the readers. Something that you would be able to recall at a moment's notice while investing. 5M™ and MECOM™ are essentially mnemonic triggers to do just that.

They're worded this way to help you navigate to the far reaches of your brain to help you pinpoint the most important elements for investing success. When I invest now, it's all I use. I am always thinking in MECOM now. If it can't pass the basic elements of MECOM, I throw it in the trash and move on to another potential opportunity. It's all about using time efficiently and effectively.

The cornerstone of great investing is already here -- It's just unevenly distributed. Most people just don't know about it yet…

7 Reasons To Read This Book, Even If You Hate Investing (As I Did)

A Value Investor's Journey Through The Unknown isn't just an investing book, per se, though on the outside it may look like one. Just as Poor Charlie's Almanac isn't just about investing, this book isn't quite what it appears *(I wish I was as cool as Charlie Munger).*

Even if you hate investing, here are the seven reasons you should read at least the first few chapters of this book:

#1

You'll Learn How To Become World Class In Record Time.

Whether you want to learn how to create a portfolio of high quality businesses, how to "think" about the stock market, or how to easily value businesses in less than a minute -- the true "goal" of this book is to provide exactly that: a process for investing success. The vehicle I chose is the 5M™ Mental Model. Throughout this book, I'll teach you all of the most efficient and important techniques and checklists that matter most to your investment success. Each section will take a minimal amount of time, but result in you having The Ultimate Investor Blueprint. My hope is for book to make you a master student at investing.

#2

You Will Get In The Best Mental Shape Of Your Life.

The mental models you'll learn, apart from business analysis and valuation techniques, are all compliant with "value investing." If you follow this book, you won't have to think about being lost as you make investment decisions, since this mental model is built using mnemonic triggers to help you remember the elements that matter most to investing success. If you ever decide to follow another investment process or system, you'll be twice as effective, because you'll understand how everything is interconnected from the various mental models you will learn in this book.

#3

Investing (And Life) Will Become Brighter.

I pose a question to you: have you really learned how to invest? Even while writing this book, I now realized that I hadn't. Back then, investing was part of my job. It's something I did, either good or bad, efficient or not. Now, I truly have a system and process for success. And the processes and mental models in this book go way beyond investing. It's like going from black and white TV to color. As you'll see, the mental models built into 5M™ will affect everything you do. Life itself becomes much better when you are equipped with worldly mental models.

#4

Investing Is The Confidence Advantage.

Being a great investor or capital allocator, or even articulating investment ideas better from the mental models in this book, can be a force multiplier in your confidence levels and understanding of investing. Increased confidence with the ability to support your significant other or family members is something I can't explain with words. It makes you feel larger than life. You walk in a room and people can notice the confidence.

#5

It Doesn't Take Much To Become Impressive.

In the first 24 hours, I'll take you from being all over the place in your investment process to helping you pinpoint the things that matter most to investing success. With more and more investors giving up on the stock market all together, or herding around the same stocks, it gives you a much better opportunity to outperform the general market.

#6

The Markets Aren't Rigged -- They're Beatable!

It took me years to discover just how profitable value investing really is. The reason for this book is to make sure others don't make the same mistake.

Make this book a key part of your investment strategy to earn value investing returns over the long-term. The money you could make off of even just one great idea will pay for this book many times over.

#7

Because It's Fun And Lucrative At The Same Time.

Knowing that you have a system that can lead you in the right direction to investing success can be an extremely fulfilling and lucrative endeavor that will stay with you for a lifetime. And intermittently, I will keep you entertained and amused with some stories of successes and failures along the way. Investing mental models and analysis? Check. Funny and ridiculous investing anecdotes? Got those too! After all, sometimes we learn more from our mistakes than our success. Hopefully you can learn from mine and others.

This is the furthest thing from a textbook. See the next section on how to use this book.

How To Use This Book: 5 Rules And Getting To 5 Million People

It's crucial that you follow these rules at all cost. I will not be held responsible if you don't.

RULE #1. Think of This Book As A Buffet (no...not Buffett).

DO NOT read this book from beginning to end. Just don't do it.

Let's be honest --- Most people won't even need more than 100 pages to gain incredible insight into something they were missing about investing. Check the table of contents, go to the chapters that are most intriguing to you, and just discard the rest...until you need it.

Mandatory sections depend on where you are as an investor. If you are a complete newbie, the Market and Mindset section may help you the most initially. If you've dabbled in the stock market or have a 401(k), then the MECOM™ Method and Margin of Safety sections may appeal to you most. If you are a seasoned professional, the mental models and philosophy sections may tickle your fancy. Here are some popular goals, along with the corresponding sections:

Market Mastery (understanding of the stock market)

Know Your Competition
Is It Important…And Knowable
A Complex Adaptive System
Investing or Speculating
Where to Find Opportunities
Total page count: 18 pages

Mindset Mastery (psychology)

Getting Into A State of Flow
Investing As A Leisure Activity
Approach Investing As A “Real” Business Person
Commitment & Perserverence To Succeed Long-Term
A Prosperity Mindset
Total page count: 28 pages

Morals Mastery (philosophies)

Always Think About Risk Before Return

A Contrarian Streak
Stick With A Long-Term Approach To Investing
"Few, Big And Infrequent Bets"
Agnostic of The Macro Environment
Total page count: 22

MECOM™ Method Mastery (business analysis)
The MECOM Method
Step #1: Moats
Step #2: Earnings
Step #3: Catalysts
Step #4: Obligations
Step #5: Management
Total page count: 149

Margin of Safety Mastery (valuation)
The Art of Valuation
Using A Range of Values for Intrinsic Value
Discounted Cash Flow Valuation (DCF)
Liquidation Value (LV)
Total page count: 63

RULE #2. BE SKEPTICAL.

Don't let me off the hook that easily. Seriously, I'm not kidding. If you believe some of these tips, tricks or concepts aren't correct, then lets start a conversation about it. Not only will I find it fun -- it will make me a better person and investor by looking at things from all kinds of different angles and viewpoints.

Never assume something is absolute because someone else said it -- Always trust but verify.

"True wisdom is knowning what you don't know."
Confucius

RULE #3. DON'T LET SKEPTICISM BE THE EXCUSE FOR INACTION.

It's important to always try to disprove processes and ideas, regardless of how sane or rational they appear at that moment in time. Skepticism is a worthwhile task in the pursuit of worldly knowledge.

As Munger says, "it's a year wasted if you don't disprove one of your ideas..."

Let me know if you have additional elements to add to the system or prove me wrong. Through your feedback and help, this system and book will continue to evolve over time.

RULE #4. SKIP THE MATH IF IT'S TOO DENSE.

You do not need to be a mathematician to read this book.

I've included many details and calculations for the geeks and curious individuals out there. However, they aren't required to achieve the results you desire.

I encourage you to browse these sections, however there is no reason to be intimidated by it. They are aren't mandatory to achieve investment success. So if you're overwhelmed with any of the information or calculations, just skip them.

RULE #5. HAVE FUN WITH IT.

All facts and figures makes for a very boring read. I've included numerous stories and case studies for your enjoyment and added value.

The content is meant to be read and processed as you wish. Although it's a blueprint and system for investment success, you by no means have to read it from beginning to end in one session. It's encouraged, but not necessary.

Enjoy the exploratory and discovery process. Have fun with it. Remember: this isn't a school assignment. Take it at your own speed.

OUR BIG GOAL -- 5 MILLION PEOPLE

I was visiting my family for the holidays just like anyone else, but this year was different.

It was Christmas of 2008, and it seemed the world was coming to an end. Major Wall Street firms were going under. I was even a little scared by the whole environment.

All my family members were asking me what to do: “Should I take my money out of the stock market?” “What should I do?”

First off, I never give investment advice. Everyone is their own person. They are more than capable of making their own decisions. But this time people were panicky. There was a dire look in Grandmother’s eyes as she saw her hard earned saving dwindle during this stock market nervousness.

I felt bad. I told my family, “its probably the wrong time to sell now.” I mean, the market was down already around 30%. I said, “as long as you’re invested in high quality, cash flow generating companies that you believe will be around for the long haul, then there is no reason to panic and sell at these levels. In fact, you should probably be buying more."

This is usually when I get that side head tilt that is a normal occurrence from my boxer dog, "What do you mean buy more? It's going down." Most people can't comprehend that a security actually becomes less risky the lower it goes (as long as you've identified a high quality investment opportunity).

So I left that night feeling pretty good about myself. Hopefully I had staved off disaster for my relatives. And hopefully I had kept them from falling prey to Mr. Market's funny little game of volatility, and "lets see how low it can go before you sell…" Mr. Market can be really sick sometimes.

Anyway, fast forward three months and the market took another leg to the downside in early 2009. Before it was all said and done, the market had corrected 50% from high to low leaving many market participants scratching their heads, and wondering what the hell happened.

Our next family get together was around 4th of July. It had been a horrible couple of years for me as an investor, however things were starting to turn up. Of course the topic of the dinner table revolved around this crazy stock market and everyone's retirement accounts.

I wanted to know how everyone made out, and to my utter amazement, almost every one of my relatives had sold the majority of their holding in February and March of 2009 because the pain of losing money was too difficult to bare -- my jaw hit the floor.

They knew nothing about the businesses they were investing in, and as a result they panicked and sold at a time when they should have been doing the exact opposite.

There was a major disconnect between how people ought to invest and how they think they should invest. And this is the reason behind the 5M™ Mental Models and this book: arm individuals with the right mental models to invest better.

Prudential conducted a survey in 2011 asking, "when are you likely to put more money in the stock market?" Shockingly, 44% said they would "NEVER" put money back in the stock market to invest. 58% said they had lost faith in the stock market all together.

These emotional responses of fear and uncertainty kept individuals from making rational decisions. Many weren't armed with the right set of mental models to make the decision-making process easier on themselves.

Today, things aren't much better. The world is turning a blind eye to "real" investing, with many still wanting nothing to do with the stock market. Or if they are investing, individuals rely more and more on "passive" strategies such as index funds and asset allocation strategies in their 401(k) policies or IRAs to help them invest in the markets, all the while making them think it's safe (and collecting management fees).

There is a better way!

In other words, the mental models you learn in this book will do a lot of good beyond you and your family. Our investing behavior and philosophy can help decide who the future wealth generators are in the country.

My goal is to reach 5 million people. And that's just the tipping point. Imagine 5 million happy investors with the confidence and understanding of how to invest how he/she wants, without the noise of the overall market. And without having to deal with money managers taking management fees from simply tracking an index.

It's never an easy task to begin something new, however subtle changes can create a snowball effect that is likely to be felt for a lifetime. A mind developed and armed with an arsenal of the right mental models is power.

This book is not the end all, be all of value investing books or mental models. But it does contain many valuable truths and philosophies to help you improve as a thinker and investor. Whether you choose to use the models within this book or not, is entirely up to you. Either way, I will help you find your own way if your thought process deviates from ours.

Enjoy the journey!

STANDING ON THE SHOULDERS OF GIANTS

I am not a master investor, nor am I an expert.

I'm your humble guide in your journey to investing success. Thanks to the people below, we have been able to compile concepts, theories, philosophies, and ideas into a finely detailed mental model for our reference, any time we need it. Any mistakes (or anything odd) you encounter in this book is no fault of anyone below. It was all my doing.

Although there are hundreds who have helped me in my journey, below is a list (in no particular order) of the many who had a lasting effect on the creation of the 5M™ Mental Model you will learn within this book (see more in the acknowledgements section at the end):

Whitney Tilson
Jacob Wolinsky
Bill Ackman
Tim Melvin
Guy Spier
David Einhorn
Scott Greenberg
Rob Sckalor
Warren Buffett
Mohnish Pabrai
Charlie Munger
Mason Hawkins
Donald Smith
Scott Barbee
Peter Cundill
Bill Miller
Howard Marks
Tony Robbins
Tim Ferriss
Joel Greenblatt
Nassim Taleb
John Mackey
John Templeton
Vitaliy Katsenelson

Mitch Kovitz
Joel Hirsh
Jon Shapiro
George Soros
Pat Dorsey
David Gardner
Todd Combs
Ted Weschler
Jae Jun
Tim McElvaine
Chris Hohn
Noah Kagan
Brett Fogle

From Wall Street To The Human Condition:
The 80/20 Principle In Action

I woke up in a daze--it felt like I was upside-down. In that moment, an odd sense of weightlessness came over my body. I thought to myself, “maybe I was just dreaming.”

As I finally 'came to', blood was running down my face. It was at that moment I realized I WAS upside down. At this point, all I could think about was getting out before the car envelops into flames.

With blurred vision, I looked over at the passenger seat, not having remembered if anyone had been in the car with me. Thank goodness no one was there. I thought to myself, "at least no one else was harmed."

Once the car eventually came to a stop, and I gathered myself, I was able to climb out of the smashed driver’s side window. 30 seconds after somehow stumbling out of the car, the car burst into flames. "Whoa", I thought to myself, "that was close."

Sorry, I am getting ahead of myself here...let me rewind to the beginning.

In late 2007, I had just moved back to St. Thomas, located in the US Virgin Islands (where I was born and raised). I had spent the previous year in Washington, DC, working for an Intellectual Property Law Firm, and I had my heart set on law school. That is, until I realized I was spending the majority of my time researching businesses and investing my savings.

I was a regular person who worked, saved some money and tried to invest. So it was really by coincidence that I realized what I wanted to do the rest of my life. That is what brought me back to St. Thomas, the opportunity to work at an investment firm.

I had been working at the Investment Firm for about a year, working very long hours at the office to prove myself to the owners and my colleagues. Maybe I was trying to prove something to myself too. I would consistently wake up around 4:00am to read and research, and would usually leave the office at 7:00 PM or later during the weekdays. The weekends were not much better. I was downright exhausted.

This brings us to the moment that changed my life FOREVER. That eventful car ride home on a Friday night would be a turning point in my life. Little did I know it at the time, but it would be a blessing in disguise.

It was an interesting time in my life. I had spent years trying to figure out investing. I thought I had an understanding, but the “Great Recession” caused almost everyone to second guess their approaches to investing (including my own).

Things were starting to recover but people were so hurt from the preceding two years of markets turmoil that market participants didn't believe anything anymore. They thought the stock market was one big virtual casino now.

People were knowingly selling companies for much less than they were worth. I, on the other hand, thought it was a great time to be a value investor if you had the moxy to follow a true value investor philosophy.

Thankfully I kept purchasing my best ideas. Things were starting to turn up for me, but at what cost? I was so exhausted and tired. The days seemed to blur together into one, until it finally happened.

It was Friday night in September, 2009. I'd spent about 80 hours at the office that week and it was only Friday. I decided I needed a break so I went out with a few of my good friends to a local pub. I left to head home a little after midnight. It was a normal St. Thomas night with the conditions dark and around 80 degrees. The windows were down and I was listening to BB King. I know, probably not the best to listen to jazz music while driving home at night.

We drive on the left side of the road in the USVI. So I was traveling on the left side of the road on the north side of the island heading towards my house when the unthinkable happened:

I FELL ASLEEP AT THE WHEEL.

The car had veered to the left of the road over the white line, and hit a drain pipe. After the sudden crash, the drain pipe acted as a ramp and sent the car air born twisting sideways. This is when I woke up to the car flipping and rolling over across the road and then sliding along the guard rail on the right side of the road, and eventually coming to a screeching halt facing the other direction.

It was an odd feeling of weightlessness initially. Then came the ferocious body-rattling, thrashing and violent careening that only a professional race car driver could know.

When the car finally came to a stop, I didn't say a word. I knew I had to get out of the car -- FAST.

I was in a hurried state, but an eerie sense of calmness was over me as well. I assume the adrenaline was kicking in at this point.

The passenger side window frame was smashed in and the driver's side window was equally as bad. The entire left side of the car was also lodged up against the guard rail. I pulled myself through the small opening between the guard rail and the car window, cutting my arms and hands as I reached for freedom. Blood was starting to pour out at this point. I remember having glass in my hair for weeks from climbing through that window.

I know what you are thinking -- WHAT DOES THIS HAVE TO DO WITH INVESTING?!?!?

Don’t worry I will get to that shortly. I want you to know how this whole process started, so that you can see all of the trials and tribulations it took to create the mental models you will learn about in this book.

There will certainly be times in your life, and in investing, when you think you are down for the count. It is essential to learn how to deal with these moments if you are to succeed in life and investing.

Personally, I have experienced a lot of tragedy in my life--I have had a best friend die in my arms from an asthma attack when I was 13 years old while studying for our final exams, and lost my father suddenly when I was 23 years old leaving me as the head of the household. All of these experiences made me stronger as an individual, but it was so painful at the time.

I tell you this not to depress you or to ask for sympathy. Quite the opposite in fact. We can all learn from difficult situations and continue to evolve and grow. Each tragedy has changed my life for the better.

That’s how you have to treat less than fortuitous events or situations. Every set back is an opportunity. That’s life -- when you fall down or stumble, you have to learn how to pick yourself up, learn from the situation, and keep going forward.

I had no idea at those moments of extreme emotional pain that it would guide how I look at people and the world. Those moments gave me a strong threshold for pain (physically and mentally), but it also made me understand the important things in life.

I am always of the belief that these things happened because I could take it. I have always sought out to accomplish difficult things. As they say, the bad times make the good times better.

The key learning point from these experiences in my life is that you must have that ability to FAIL FORWARD. The dark times are nothing more than an opportunity in disguise. It is just tough to see it at the time.

That accident was a pivotal point in my life.

When I had time to reflect on what happened, I thought about how close I had come to dying. It made me think a lot about myself, my life, my future and what I wanted to be remembered for in life. I realized I had to incorporate certain habits and boundaries for myself in life and I needed to create a process and a system that would help me to invest more efficiently and effectively.

The reason that experience changed my life forever is that it made me realize that something had to change. I loved my job too much to quit, it's what I love to do.

However, it was killing me. I had to create a system that would help decrease the learning curve for investing and business research.

Little did I know that night, an economist would be the one to help change my life forever. It's too bad he had passed away 100 years ago, I would've loved to have met him.

The man who changed my life is named Vilfredo Pareto. He popularized the 80/20 principle, or Pareto Principle.

I know...I know. Parteo's Principle, or the 80/20 principle, has been paraded around the media as a way to "hack" your way through life or your career (or anything for that matter). And normally I would cast off such things that have become so popular in the main stream media. However, the disconnect occurs from people not using this simple principle (thus, we are safe for now as contrarians).

Important note: Although, Pareto was the first to popularize the concept, Tim Ferriss (Author of the Four Hour Work Week, et al) was the one that lead me to Pareto, and this way of thinking. So he has just as much an impact on my life as Pareto, and for that I am entirely grateful. Thanks Tim!

Pareto essentially established that "80% of the output from a given solution or system is determined by 20% of the input."

Here are some examples of the 80/20 principle:

- 80% of the outcomes come from 20% of the efforts.
- 80% of ramifications come from 20% of the sources.
- *More specifically:*
- 80% of a business's profits come from 20% of the actions.
- 80% of investment success comes from 20% of the elements.

This list really does go on forever. In fact it would probably take an entire book to discuss how Pareto's principle affects out lives on a daily basis.

And the ratio is often even more disproportionate. It's not uncommon to see 99/1, 95/5, and 90/10. Our focus will be on the 20% that gets us 80% of the way there. Once we get to the 80%, then you can hone in and focus more on the task at hand.

When I first came across his work, I was slaving over 12-15 hour days as a portfolio manager at an investment firm managing the Value Portfolio. It was no one's fault but my own. I wanted to learned as much as possible, as quickly as possible. I had to know everything, and all the businesses I was interested in.

It took that near fatal car crash to realize that there needed to be a better way. Little did I know at the time that the near fatal crash would end up changing my life forever.

Leading up to the crash, I was completely over my head and generally helpless. Even worse, I had no idea at the time. I was waking up at 4am to let my boxer dog (Harley) out for a walk and I would start reading or researching something -- anything I could get my hands on that I thought could help me. When I wasn't coaching football as a volunteer head coach after work during the season, I was usually at work until 6 or 7pm. There was no end in sight.

The day after the crash (with glass still in my hair), I opted to give Pareto's 80/20 principle a chance. I thought to myself, "Why not...I did almost died right?"

In trying to ascertain how I was going to continue investing and managing money without killing myself, I scrounged up ONE question that would lead me down my journey to the unknown in investing:

Which 20% of elements are resulting in 80% of the results for investing success?

It's certainly not an easy answer. Anyone would be skeptical of trying to answer this question. But this wasn't going to keep me from trying.

How did I do this, you ask…?

Well, it wasn’t easy.

I interviewed investors, studied countless more, and pulled out repeatable strategies and tactics they used (or didn’t use) to succeed.

"The art of being wise is the art of knowing what to overlook."

William James

I began to study my previous successful investments (and the bad ones as well) and I deconstructed and reverse engineered other investors top investments and failures. They have been used, refined and systematized into what you read today. You will learn more about the formulation of the 5M™ Mental Model and MECOM™ Method later.

However, this is the formula I used in search of a simple system:

80/20 Formula = Which 20% of (sources/elements) are resulting in 80% of the desired (outcomes/problems)?

As you can imagine, the difficulty lies in establishing what 20% will lead to 80% of the results. That's the entire reason for this journey --- and the eventual creation of the 5M™ Mental Model (we will get to this soon).

Although I have a natural affinity towards value investing, I also have an understanding of how dynamic and challenging it can be. I find value investing to be the most intriguing, fun, frustrating, depressing, lucrative, and exciting career you could ever have (I know that was all over the place).

And that's the beauty of Pareto's law. It helps you to "see the forest through the trees." It helps you to focus on the most important elements first. Once those elements are executed or perfected, then you can venture outside of it.

REMEMBER: being busy for the sake of being busy is a form of laziness. It's lazy because it doesn't take into consideration the elements that will actually produce results.

Focusing on the important few, while discarding everything else, is the way to a productive life. Of course, you will need to try many different things to ascertain what matters most. This can be frustrating at first, but it's a necessary process to see what "sticks on the wall."

It could take a few days, a few weeks, or even a few months. However, once you've conducted this important process, you will know what works and what doesn't. It's just part of the process. So there's no need to get frustrated by it.

Once you implement the 80/20 principle into your life, you will never go back. *Guru Investor Edge*, *Value Investor Confidential* and 5M™ are just a few of the many examples of the 80/20 principle in action for investors that you will learn about in this book.

Using the investing version of 80/20 analysis, my goal in this book is to help you gain an advantage in understanding whether any business has the potential for investment. Thus, saving an investor hours of wasted time and energy.

We have set-up **Life Time Access** to *Guru Investor Edge* ONLY for our readers. Follow the hidden link below:

https://GuruInvestorEdge.com/LifetimeAccess

I told you I would have surprises and gifts for you. I am all about giving and adding value to people’s lives beyond the norm.

My Story

Congratulations on your decision to invest in *Value Investing: A Value Investor's Journey Through The Unknown*. My name is Lukas Neely, and I am the Founder of EndlessRiseInvestor.com and Value Investor Confidential (a premium monthly newsletter for Endless Rise Investor readers where we conduct in-depth interviews with top performing investors on their best ideas).

It took a car crash that almost ruined my life to start seeing things a little more clearly. I came to a realization early on in my investing career as a Hedge Fund Portfolio Manager that:

YOU CANNOT BE A SUPERSTAR IF YOU FOCUS ON EVERYTHING!

Over the last 10 years I have developed a simple Mental Model and Method to help investors build portfolios and find incredible investment ideas. The components of this Mental Model, and the Methods within, have been used by the greatest investors of our generation and beyond, helping them reach investment returns in the billions of dollars. We invested hours of research, development, and tweaking to maximize effectiveness and efficiency.

For the first time ever, I decided to put the entire mental model together so that you, the individual investor, can get similar results for yourself and your family. These are the most important components to investment success!

If you need to understand the stock market better, we have a section for that.

If your psychology, or mind, is getting in the way of your investment success, we have a section for that, too.

If you need help with portfolio management or asset allocation, we're going to cover it in this book.

If you need help with developing an investment philosophy that fits your personality best, we'll walk you through it.

If you need to learn how to analyze a business quickly and efficiently, we'll give you the tools (as well as bonus materials, valuation templates and checklists at the end).

If you need help with buying and selling decisions, you'll also find that inside.

If you need to learn how to value a business quickly and efficiently, using *discounted cash flow or liquidation value,* we have a section for that too.

This book is unlike most books on the subject of investing. It is written in an easy-to-read format so you can easily come back to it as a reference for your investment decisions, time and time again.

Most investing books are theoretical, or are written by people that have never truly managed money. The system you will find in this book was born from years of in-depth research and analysis. We developed it into a viable and understandable process while using the mental models in the real world to manage millions at a Hedge Fund.

When you apply the techniques and tips in this book, you will become twice the investor in half the time

Please Store this Reference Book in a Safe Place.

I promise that you will come back to it over and over in the coming years to model your investment process after what we have inside. Use it, mark it up, and make it your own. Use it as a reference anytime you want.

“Life is like a snowball. The important thing is finding wet snow and a really long hill.”

Warren Buffett

As you keep using and adapting the Mental Models and Methods within this book to fit your own personality, it will create a snowball effect. From an initial state of trivial significance, a person can accomplish wonders by acquiring worldly mental models. These mental models will build upon themselves until it becomes bigger and bigger. This knowledge will continue to build until it becomes nearly impossible to stop.

Not only does this relate to your investing -- but life as well.

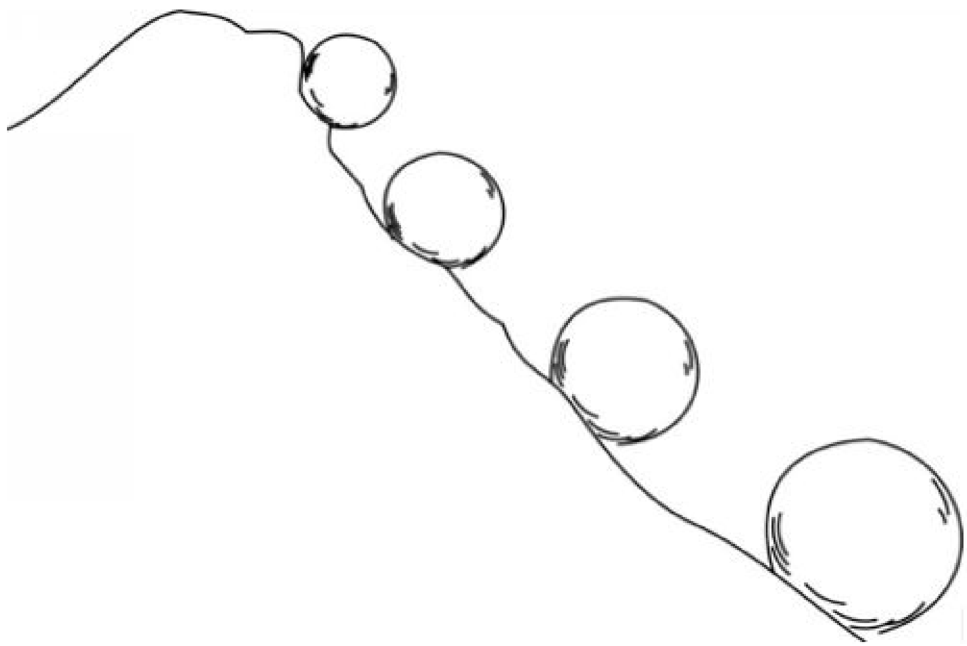


FIG:1 The Snowball Principle
*This image will be placed next to important ideas and concepts throughout the book.

If you’re ready to become a Super Investor, then let’s get started…
Enjoy!

The 5M™ Mental Model

Do you want to know what makes the difference between a great investor and a mediocre one?

Don't dodge the question.

Try to answer this question as honestly as possible, because it's the basis of this book and our overall goals as investors.

Remember: I've done this for a living. I've managed money professionally. As a result, I believe I have fairly good understanding of what it takes to be successful in investing.

And I don't say any of this to brag either. Anyone that knows me, knows that's not how I operate. I just say it to impress upon you that what you read here today is born from real-world experience and with real money on the line.

In trying to answer the question above, I've spent the last 8 years studying and evaluating hundreds of investors; some great ones, and others who, how do I put this politely, needed a lot of help.

I've read over 250 books on investing, the art of valuation, behavioral finance, portfolio management, and asset allocation. I attended numerous seminars and conferences, and bought nearly every newsletter on the subject. I consumed every piece of information I could get my hands on to find the best way to invest.

I have interviewed some of the greats, ranging from Vitaliy Katsenelson, Mitch Kotivz, Joe Koster, Jon Shapiro, and many more. I was even taught by a couple of the masters, Whitney Tilson and Glenn Tongue (formerly T2 Partners), at an advanced value investing course at the Value Investing Congress when I was 24 years old.

I was looking for a system or process which would help *anyone* become a powerful Super Investor.

What I found was quite interesting…**there's no magic pill or push-button solution that will guarantee investing success.**

What I found instead were certain mental models, little-known techniques and philosophies that are used by some of the world's greatest investors to produce their incredible excess returns.

In this special book, I'll reveal to you the investing techniques and processes of the greatest investors. I have also put it together in an easy to digest mental model for you to use over and over again to your heart's desire.

My intent is to give you a basic step-by-step resource to investing and building on each component of 5M™, including areas you will need to develop and master in order to become a thriving investor.

Here is 5M™ and the 5 areas to master in order to build and grow your nest egg (Fig. 2):

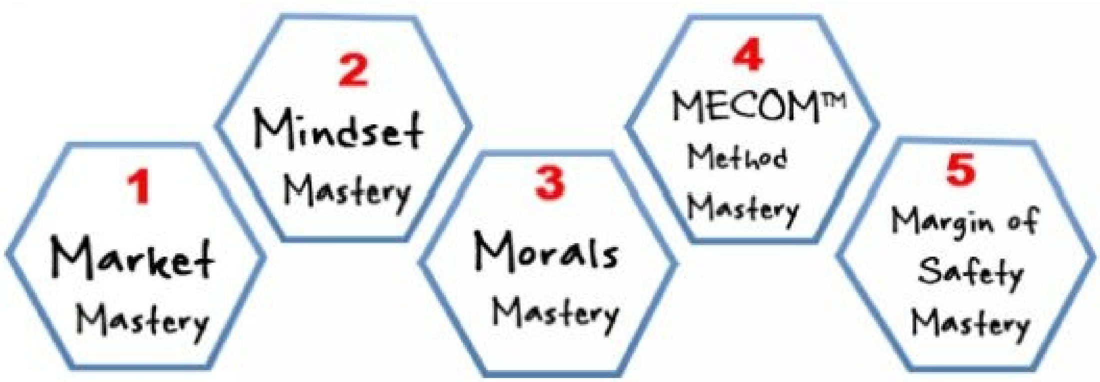


FIG. 2: The 5M™ Mental Model

Mastering any one or two of these steps will serve you well, but having a solid understanding of ALL five steps and phases of 5M™ will put you well on your way to investment success, as well as putting you in the top tier of all investors.

A SIMPLE, PROVEN, REPEATABLE SYSTEM IS THE LIFEBLOOD OF EVERY SUCCESSFUL INVESTOR.

Now that you have an overview of the 5M™ Mental Model, we will go into detail on each component of the 5M™ Mental Model.

PART 1: MARKET MASTERY

Do You Know Your Competition?

"Mr. Market is there to serve you, not to guide you."
Benjamin Graham

If you remember in the last section, we explained the 5M™ Mental Model and how it provides a simple, proven and repeatable system for investing success. Since you now have an overview of 5M™, we will dive into the details on each of the 5M™ components.

In this chapter, we will discuss the first section of 5M™ and learn how to Master the Market. By the end of this section you will know how to:

- Analyze your competition and how to beat them.
- Determine whether variables are both important & knowable.
- View the market as a complex adaptive system.
- Determine whether you are investing or speculating.
- Find opportunities in the market.

THE STOCK MARKET IS A PRODUCT OF HUMAN ACTION…AND HUMAN ACTION CAN BE HIGHLY IRRATIONAL, FEARFUL AND GREEDY *AT TIMES*.

As long as humans control the decision-making process in the stock market, the stock market will continue to act like humans. Human emotional action, and reaction, creates unpredictable cycles of excitement, fear, depression, euphoria, calmness, action and inaction. And it will constantly repeat itself over time.

REMEMBER: “the market is only there to serve you, not guide you.”

Independent thought is vital as you determine the value and staying power of the business that interests you. This will help you profit from the underlying business fundamentals, rather than market folly. Focus on the fundamentals of the business, not movement in usually irrational stock price behavior.

As an investor, you are in a great position to take advantage of Mr. Market's irrationality and emotional response, when you buy at a discount to the intrinsic value of the underlying business. We will discuss a business's intrinsic value later in the Margin of Safety section.

Contrary to popular belief--you need to envision Mr. Market knowing nothing.

If you visualize Mr. Market as nothing more than a place that quotes stocks based on irrationality and emotion short term, you will consistently look for opportunities that present themselves in your watch list.

It will be the investors that take advantage of Mr. Market's short term irrationality that have the best chance of enjoying long term investment success. Speculators and short term traders will inevitably have an uphill battle as they constantly fight market noise and transaction costs.

Know Your Competition

"If you know others and know yourself, you will not be imperiled in a hundred battles; if you do not know others but know yourself, you win one and lose one; if you do not know others and do not know yourself, you will be imperiled in every single battle."

Sun Tzu

(Chinese Military General)

"This game is too hard…"

"I can't hope to win or compete with the likes of the "big boy" hedge funds and banks…"

This is the general sentiment toward investing in the stock market, and essentially this sentiment is correct.

However…

Instead of finding areas where an individual investor could be successful, he/she still invests like the rest of the market, which is exactly what the big Wall Street players want you to do.

"When you play in someone else's sandbox, they are going to make the rules."

Noah Kagan

In this section, we will point out some weaknesses of the market, so you will be better-equipped to make great investment decisions.

Investing long-term goes against the very nature of Wall Street. They make very little money if investors just buy and hold investments. They would cease to exist in their current capacity if all investors did this. Now with that said, I also don't think they are going anywhere, anytime soon. So, it's best to understand them and their rationale behind various decisions.

Wall Street is everywhere: CNBC, Bloomberg, newspapers, financial reports, getting a mortgage for your house. There is very little you can do to evade them on a daily basis.

Because their very existence relies on activity, Wall Street cannot afford to be contrarian. Major Wall Street firms cannot pay their bills with customers who won't generate a lot of commissions for the firm.

I will probably get a lot of hate mail for this, BUT investors would do well to avoid interactions with Wall Street (as best you can).

It is important to keep in mind you cannot blame Wall Street for their actions. They are merely fighting for survival, doing what they were taught to do.

Does it make it right? Of course not.

But it’s like blaming the shark for eating the seal. Animals have been hardwired a certain way over centuries. It is difficult to reverse that instinct in any person’s finite lifetime.

It’s not the individuals, it’s the system and the incentives that need to change. (My guess is this will never happen. Too many people are making too much money to let it go now.)

The bottom line: what's good for investors is not necessarily good for Wall Street (and vice versa). The interests are not aligned properly for Wall Street to serve as stewards of long-term capital.

Most of Wall Street gets paid on transactions, not how effectively that transaction ultimately does over the long run. Underwriting fees, Investment Banking fees, and commissions are usually paid up front, and collected from each trade or transaction, regardless of whether the security goes up or down. Now, you can begin to see why Wall Street wants you to keep transacting more and more (it’s how they get paid).

Outside of commission fees to brokers, *mutual fund managers* are paid 'management fees' to cover day to day expense and salaries, regardless of how the actual fund is doing.

Hedge Funds typically charge a 2/20 fee of assets under management. This means a 2% management fee and 20% of profits (sometimes above a hurdle rate). Through my conversations with some hedge fund managers, and having been in the industry for a number of years, the fund usually pays all of its bills, salaries, and bonuses from the 2% management fee. The 20% performance fee is just a “cherry on top.”

Essentially, there is no real incentive for them to perform. All they need to do is make sure they keep your money, and perform relatively in-line with the major market indices.

It seems *registered investment advisors* are popping up everywhere nowadays and essentially act as a “fund-of-fund” or mutual fund. They may tout themselves as having lower fees then their competition, but they are still charging management fees of at least .5-1% and then recommend an appropriate asset allocation strategy with additional fees.

Do you recognize a theme going on here…?

Wall Street is slowing becoming a commodity business.

Because of the lack of independent, contrarian thought, the big players are chasing each other’s tails and concentrating in the same areas as their competitors. This provides no real value to YOU, the investor.

Very few firms on Wall Street have the incentive to make you money or generate a significant amount of Alpha (outperformance) for your portfolio. Listening to them may feel like the right thing to do because they are the “experts,” but it’s really just lining their pockets, not yours.

If everyone just followed the Warren Buffett Partnership fee model, we probably wouldn’t have near the amount of aggressive activity or risky behavior that we see on Wall Street day-in and day-out.

In his early partnerships, Warren Buffett charged a 0/25 fee.

Which means there were no management fees, and he kept 25% of the profits.

Wait there’s more…

He only took 25% of the profits if he made you at least 6% on an annualized basis (or “hurdle rate”).

So if you earned 5% or if you lost 20%, Buffett earned nothing.

How’s that for incentive?

If he didn’t make money for his investors, he had to foot the bill out of his own savings to pay for staff salaries, his own bills or pay bonuses.

How many Wall Street firms would be able to do this…?

That’s an easy answer…NONE!

Obviously there are many other market participants’ brokers, institutional funds, etc., and to write about them and detail all their strengths and weaknesses would take at least 500 pages.

The reason I point this out is to show how Wall Street and the Stock Market are incredibly short-term oriented, and put very little emphasis on the fundamentals of the underlying business.

There is very little reason to look beyond the next quarter or next year because they are concerned with commission based activity or just trying to match the major market indices for management fees (closet indexing).

Because of the stock market’s short-term orientation, individual investors are provided opportunities in certain areas of the marketplace.

Knowing who you invest against can provide insight as to where opportunities will present themselves. Wall Street institutions and Hedge Funds dominate trading and flow of funds in the market. Being ignorant of their tactics and behaviors is sure to be a detriment to your investment success. Looking for opportunities that are caused by the short-term nature of Wall Street is ultimately a worthwhile endeavor.

Not having knowledge of Wall Street's short-term behaviors and decision making process is akin to entering the forest without the map.

The time to have the map is before you enter the forest.

We will discuss where to find these opportunities at the end of this chapter.

Is It Important & Knowable?

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."
Mark Twain

One of the world's best-known investors, Warren Buffett, has consistently explained that most investors make a major mistake in their investment strategy. This mistake is that they put the emphasis on what they can know, but not enough on whether it is or is not important.

There are plenty of things that we know as individuals, but many of these issues really aren't important.

Imagine you are invested in a great business. You believe in this business long-term, it is growing like crazy and has made you a great deal of money. However, there are rumors that they will be announcing a bad quarterly earnings number tomorrow.

What do you do?

Most would run for the hills on any rumor of such an event, but ultimately no one knows what the stock will do even if it were to report a bad number.

So, even if we knew that a company was reporting a bad earnings number, is it really that important if we believe the business will continue to grow and prosper well into the future?

When you invest in the stock market, you need to think about the most important components to investing success, rather than some random rumor or data set. Just because something is knowable, doesn't make it important to your investing success.

"Not everything that can be counted counts, and not everything that counts can be counted."
Albert Einstein

Only pay attention to things that are *Important and Knowable.*

A company that is doing well financially, has a great product or service, and has an excellent management team in place is a company that you should look at investing in.

If a business:

- Has sustainable competitive advantages,
- Produces a steady stream of excess free cash flow,
- Has readily identifiable catalysts,
- Has a reasonable debt levels and capital structure,
- Has a competent and trustworthy management team, and
- Trades at a reasonable price,

…then not much else matters when it comes to investing.

Would you agree that those factors are most important to investing?

I surely would!

Now, be careful. This is where many investors will try to complicate matters. It seems too simple, doesn't it?

Well, it is simple. It's just not easy. As humans, we tend to complicate things that seem to be too simple, because we think there has to be more to it. This is the main reason we must have a system to help keep us within the "lines" of finding high quality businesses for the long-term.

Research and real-world experience of managing a hedge fund portfolio have shown these components to be the most important. Time and time again they are the common components and traits of our best investments, and the greatest investments of investing legends.

Coincidence???

I think not.

The MECOM™ Method discusses the components of investing success. We will talk about this more in Section 4.

Sure, there are other factors and types of analyses. It is never "cut and dry" and no single piece of analysis fits every business.

However, the components of MECOM™ have proven themselves to be the most important components to investing success.

"Based on my own personal experience – both as an investor in recent years and an expert witness in years past – rarely do more than three or four variables really count. Everything else is noise."

Marty Whitman

(Third Avenue Funds)

If a business has all the components listed above, do you really need more information?

At that point, you've done your homework, and identified a low risk investment. Now, all you would need to do is weigh the decision against your current positions to see if this new opportunity offers better long-term potential than your current positions.

In the world of investing, unimportant excess information leads to excess mistakes.

More information and data doesn't mean better decision making.

Focus on what's most important and knowable!

Moving Away From The Macro Stuff

Too many of us still focus strongly on the macro picture. We feel it is a safer bet, something that we can better control. However, it really shouldn't be part of your main investment strategy, if you want to see a real positive effect on your finances.

Remember, we want to focus only on things that are both important and knowable. Is the macro environment and the global economic machine really knowable to any high level of probability?

Make it simple for yourself.

If it's not both important and knowable, you move on to the next idea.

The macro environment is very important, but it is not knowable to any high probability, therefore I pay very little attention to it. Our time is better spent elsewhere.

Of course, the real difficulty is identifying whether or not something is important.

Because of this, you could spend an inordinate amount of time getting to know things that may not matter in the future. It is for this reason that no market expert is able to really predict what will happen on the stock markets with any real degree of consistency. As much as we can know various things, we cannot know everything and much of it isn't important anyway.

Long-Term Thinking

If you want to invest in stocks, you must think long-term.

If you understand this, you also understand that your portfolio will grow and shrink over time. That is something you know will happen, and something that is important as well.

The importance of holding over the long-term through the "ebbs and flows" of the market is the key to long-term thinking and compounding investment success.

By focusing on this important concept, you understand that the businesses you invest in will likely be worth more 5-10 years down the line, than when you initially invested (even if the stock drops at some point throughout that time frame). Investors shouldn't let short-term trading and market fluctuation get in the way of your long-term thinking.

The reality of the matter is we cannot know what stocks will do in the short-to-intermediate term.

It's important to know, but it is inherently impossible to know with any high degree of probability, so it's a waste of time to devote too much time to it.

What you can know is whether or not a business has sustainable competitive advantages, as well as high quality assets and a high probability of producing free cash flow into the foreseeable future. These are factors every investor should focus on, and will carry the majority of the weight in determining investment success.

If you don't allow the market to compound investments over time because you want to trade actively, you are cutting yourself off at the knees.

Remember: The market is there to serve you, not guide you!

A Complex Adaptive System

"In the complex adaptive system that is the stock market … there will be dominant narratives that most everyone agrees with and that seem to provide past explanations for what has happened and predict what's likely to happen.… we don't make forecasts and conform portfolios to those forecasts."
Bill Miller

Learning how to invest is likely one of the most multifaceted lessons an individual will learn in his or her lifetime.

This is because the stock market is a highly complex system of interconnecting shares, companies, investors, and other networks that rely and feed off of each other for both success and failure. The stock market is a complex system that mankind has been trying to fully understand since its inception.

In fact, being able to accurately predict the constant ebb and flow of these rarely precise transitions within the massive backdrop that is the market, is the dream of investors across the globe.

Unfortunately, it's a dream that very few will accomplish due to the volatile and unpredictable nature of business and money.

This shows that the marketplace functions because of the dynamic network and collective behaviors within the system. Each entity within the macro-structure mutates and adapts so as to increase the possibility of survival as a whole.

In its simplest form, a complex adaptive system can be broken down into heterogeneous agents.

These agents, or investors and speculators, interact with each other, and the market, similarly to a colony of ants. This is called "emergence" because the patterns and regular processes become recognizable in the much larger entity of the stock market from the interaction with smaller entities, like traders, brokers, and shares.

This system can't be reduced to a pile of information through reduction or deduction, but must be calculated through a complex method of all interactions occurring, and the understanding of how they cause change in one another.

So what does all of that mean?

Essentially it means that cause and effect are not statically linked.

And by that I mean, just because something happened in the past, it doesn't mean you should expect it in the future.

Just because the economy is at the same debt-to-GDP level as it was in 1929, doesn't necessarily mean we are going to encounter another Great Depression and market crash of 80%.

With that said….

Observing past behaviors during certain events is certainly an interesting and fun endeavor. Seeing how behavior develops and forms into feedback loops to increase or decrease the effects can help yield understanding.

“History doesn't repeat itself, but it does rhyme.”
Mark Twain

The complexities of so many different interlocking pieces, living and invented, adapting within themselves to build and break down such a large scale system, make the stock market seem like a sentient organism.

It also makes it one of the most unpredictable systems in the world. Its intricacies and wildly unstable behavior, such as the dot.com boom (and bust) and the big market crash during 1987, make it understandable that individuals leave the stock market and investing, never to return again.

So what do we do about it?

Nothing really.

You should expect boom and bust periods. Expect the unexpected. Never lean too far to one side of the market's bearish or bullish perception.

Trying to guess what will happen in the stock market is a fool's errand.

An investor will be better served to focus on the most important factors and components to investing success.

Investing or Speculating

"The stock market is filled with individuals who know the price of everything, but the value of nothing."
Phillip Fischer

Ultimately, there are only two types of market participants---Investors and Speculators.

Understanding the difference between the two is VITAL to achieving leisurely, long-term investment success.

The Investor

Investors believe that stocks represent a fractional ownership stake in a REAL business.

This is the same mentality for bonds. Investors see bonds as the loans to that REAL business. Investors look at the underlying fundamental value of a stock and assess its intrinsic value when making buy and sell decisions.

Only when an investor has an edge do they act; the moment when they know that there is that elusive difference between perception and reality.

That’s when true investors act (buy or sell). Ultimately, the decision will be based on intrinsic value, and whether there are better risk-adjusted investment opportunities elsewhere compared to your current holdings.

Investors have a greater probability of ascertaining that moment of difference between perception and reality, because they are aware of the underlying fundamentals of the business.

The ultimate goal of the investor is to buy securities that offer a reasonable rate of return over the long run, considering the risk incurred.

Risk is the key to any investor's decision making process.

The Speculator (Trader)

This is when you hear from normal folks about this stock or that “hot tip” and how well they are doing in the market right now. They talk about a stock that made them 137% in 6 weeks, but you hear nothing about their exuberance 6 months later. This is the nature of the market.

I would venture to guess that more than 95% of speculators have no idea what the underlying fundamentals are of any of the companies they buy or sell on a daily basis.

Speculators are in the guessing game.

I don't know about you, but when I invest my money in the volatile stock market, I don’t want to be in the guessing game.

Every day on TV and in newspapers you get rampant speculation on what the market is going to do today or what it will do after the GDP number is reported. This level of excess information can lead to bad decision making over the long-term.

Investors don’t care about these things. Speculators and traders focus on short-term activities, technical indicators and/or quant strategies.

Remember: there’s nothing wrong with being a speculator. I was actually trained as a derivatives trader when I first entered the industry. I don’t regret it at all. I learned a great deal about the interconnections in the markets.

Ultimately, my trading days helped to develop my mental models about the interconnectedness of the stock market. And it also led me to understand that trading was not part of my personality. I fell in love with value investing soon after, and the rest was history.

With that said, speculators and traders do serve a purpose in the market just as investors do. In fact, I have many friends that are great traders and they make lots of money. You can make money as an investor or as a trader.

Personally, I know more people that have made money in investing than trading. Trading is very difficult and busy work.

So investing is better suited for someone that wants to make money leisurely.

The purpose of this section is to differentiate the two correctly so we know where you are currently.

Are you an investor or speculator?

Where to Find Opportunity in the Market

Investing is a simple concept in theory: purchase great businesses with enduring competitive advantages that are trading below their conservative estimates of intrinsic value.

However…

We know through experience that this is more difficult than most expect. With a simple mental model of checklists and a watch list of your favorite businesses, it becomes more obvious when a great investment opportunity presents itself.

The Problem…

Typically, high quality, high return, high free cash flow businesses reach fascinating levels of undervaluation very rarely.

The majority of an investor's time will be spent finding special situations, or active value type situations, by finding hidden values or investing in under-covered areas of the investment landscape (small cap space).

When an opportunity presents itself to invest in high quality businesses with a margin of safety, an investor needs to be prepared to invest and invest heavily in that opportunity.

<u>You will not get many opportunities to invest in incredible businesses at incredible prices.</u> Don't be scared of the moment. Relish the opportunity!

Always update and maintain your watch-list and prepare for such situations.

And you will be ready to purchase those kinds of investments when they present themselves.

Market Inefficiencies: How Opportunities Are Created

- *One-Time / Fixable Events:*

    Oil Spills
    Natural Disasters
    Terrorist Attacks
    Bad loans

- *Macro Events:*

    Recessions
    Depressions
    Cyclicality

- *Forced Selling Events:*

    Deletion From Index
    Dividend Elimination
    Stock Trading Under $10
    Year End Tax Selling
    Busted Mergers

- *Underfollowed / Unfollowed Business:*

    Small-Mid Cap Businesses
    Low Volume
    Boring Businesses
    Business No Longer Reporting Financials

- *Special Situation Events:*

    Spin-Offs
    Assets Conversions
    Merger Arbitrage
    Chapter 7 and 11 Bankruptcy (Be Careful!!!)

Where To Find Investment Opportunities:
High Quality Investment Ideas:

www.GuruFocus.com
www.EndlessRiseInvestor.com
www.InsiderMonkey.com
www.GuruInvestorEdge.com
www.MaketFolly.com
www.hvst.com

Special Situation Investment Ideas:

www.SpecialSituationsMonitor.com
www.BaseHitInvesting.com
www.CSinvesting.org
www.ValueAndOpportunity.com
www.ValueLine.com

In this section, we covered your competition in the marketplace, the variables that are most important, the market as a complex adaptive system, the difference between investing and speculating, and how (and where) to find opportunities in the market.

In the next section, we will learn how to Master Your Investment Mindset (psychology).

Susceptible investors will be tested by the many offerings and temptations of the stock market. It is easy to speculate instead of invest for the long-term.

We are all emotional human beings.

You need to be aware of the vagaries and fluctuations that the stock market will throw your way. By being prepared, you will better be able to reign in the wrong emotional response. Prudent investors will always wait for the right opportunity that Mr. Market will eventually provide.

Understanding the difference between speculation and investing will serve you for a life time. And it will grow your future wealth accordingly.

Let’s get started on the next section!

PART 2: MINDSET MASTERY

Do You Have The Proper Behavioral Toolkit To Be Successful?

"A lot of people with high IQs are terrible investors because they've got terrible temperaments. And that is why we say that having a certain kind of temperament is more important than brains. You need to keep raw irrational emotion under control. You need patience and discipline and an ability to take losses and adversity without going crazy. You need an ability to not be driven crazy by extreme success."

Charlie Munger

If you remember in the last section, we learned how to Master the Market, and how to let it serve us, not guide us.

Since you now have Mastery of The Market and know how to find investment ideas, we will now dive into detail on Mastery of Your Mindset.

In this chapter, we will learn how to Master Your Investment Behaviors and Psychology.

By the end of this section you will know how to:

- Get into a state of flow.
- Invest as a leisure activity.
- Approach investing like a "Real" business person.
- Have the commitment and perseverance to succeed long-term.
- Have a prosperity mindset.

In order to achieve incredible long-term returns you need to not only have an ability to condense informational and analytical data (which the MECOM™ Method will provide later), but you must also have a behavioral advantage over the average market member.

How do humans make decisions?

It's quite simple really: humans will normally seek pleasure or run away from pain. It's what behavioral psychologists call your "fight or flight" response. Just knowing this information alone will go a long way in understanding how we can better equip ourselves to handle averse psychological biases.

Unfortunately, pain and fear are the most powerful motivators when it comes to people making decisions. This can have a disastrous effect on investing.

The average market participant is emotional and lacking adequate information to make rational and logical decisions. The average market participant knows "the price of everything, but the value of nothing." I would venture to say with high probability, that 95% of market participants are short-term in nature. Essentially, the average market participant views the market as a gigantic virtual casino.

This means that when a market participant sees the value of his/her portfolio turn negative, they will be more prone to making irrational decisions. They make these decisions because they have no understanding of the market or the businesses they are invested in. They were always standing on shaky ground; they just hadn't realized it yet.

This unfortunate human behavior of avoiding pain gives investors, like us, a great opportunity.

Take a look at the next figure (fig. 3).

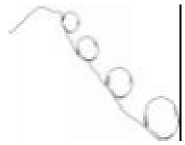
More than likely, we have all had these feelings when investing.

I know I have.

FIG: 3 Human Psychology in the Stock Market

Print it out, pin it up on the refrigerator or in your office.

Just make sure you remember how feelings and emotions can affect the markets, regardless of fundamentals.



Getting Into a State Of Flow

Do you know how many thoughts you have per day? 100, 500, 1,000?

Try 65,000 thoughts each day!!!

Whether we want to believe it or not, our brain can be a runaway train if we let it get the best of us. It can cause us to elicit certain responses if not trained properly. Some of these responses can be detrimental to progress and investment success.

The processes in this book will help counteract perverse human psychology biases, which can be a tremendous detriment to investment success.

There was a study done by Australian Psychologist Alan Richardson which shows the power of the mind.

Students were chosen at random and put into three different groups. None of the students had any experience prior to the experiment. The experiment went on for twenty days. The first group practiced free throws every day. The second group did nothing. The third group visualized making free throws for twenty minutes every day with no physical practice.

After the twenty days, the second group didn't improve at all. The first group that practiced everyday improved by 24%. The third group that only visualized making free throws improved by 23%. This was almost as much as the group that practiced every day!

Being a former athlete that’s spent countless hours practicing many different sports, I found these results to be quite interesting.

Richardson felt that, prior to any engagement, an individual should both feel and see for best success.

This is essentially the MECOM™ Method in action.

(We will discuss THE MECOM™ METHOD in chapter 5. No need to skip ahead)

As you research and analyze businesses, you are visualizing how a great investment should look through MECOM. By using this method, you’re already visualizing which factors and elements are most important to investment success, and you will be able to pinpoint them more accurately during your research phase.

To really allow the mind to focus on certain things, <u>the process must allow an individual to visualize and act on important facts or data.</u>

REMEMBER: The average human only concentrates for a few seconds.

Because of human genetics we are either spending most of the day on the left or right side of the brain. The hemispheres of the brain are popularly referred to as the logical side (left brain dominant) and the creative side (right brain dominant). MECOM™ forces you to use BOTH.

Essentially it allows you to access the whole brain by using visualization and analytical mechanisms.

Which side of the brain do you primarily operate in?

MECOM™ allows the mind to be focused on what matters most.

You will not be lead astray by cell phone usage, reading emails or thinking about life's daily problems. This focused process allows the mind to 'zero in' on a target to produce greater results in a shorter amount of time.

I cannot express to you enough how you must have basic control over your mind. The best and easiest way to do this is with a process. However, this is common sense that most people will ignore. The greatest investing tool is your brain, you cannot let it keep you from advancing in life.

It’s imperative that you allow the mind to enter MECOM™. If you want the results in the shortest amount of time (minutes instead of hours or hours instead of days), fully immersing yourself in MECOM™ is mandatory. Having a process and being completely focused on it can have breathtakingly fantastic results at the end.

Steven Kolter, bestselling author of *The Rise of Superman* and founder of the Flow Genome Project, defines flow as “optimal states of consciousness, where we feel our best and we perform our best.”

Have you ever lost a day or an evening researching or reading or finalizing a project, and not really remembering it happen?

If you have, then you’ve likely entered a state of flow without even realizing it.

I would venture to say that Flow is the secret sauce behind all great investors. However, this is a subject that is very rarely discussed in the investing world.

Let’s put it this way: at some point you’ve probably heard top athletes talk about how they are “in the zone.” For example, in 1997, Michael Jordan had the game of his life with the flu in game 5 of the NBA Finals. He was on the verge of passing out during the game but a greater force drove him to keep going.

Warren Buffett talks about it all the time too. He says it’s all he thinks about -- he’s just "wired for investing." He also has a framework to discern good investments from bad. And over the years, he's developed mental models to keep him focused on factors that matter most in investing. These mental models keep him focused on the task at hand and they keep him out of trouble. They keep him in the "zone" (or "in a state of flow").

These mental models are essentially his MECOM™ process.

Being in a state of flow can cut down the learning curve substantially, however you first need to know what you're doing. If you look at the typical chart of the learning curve process, it can be a whirlwind of emotion and frustration.

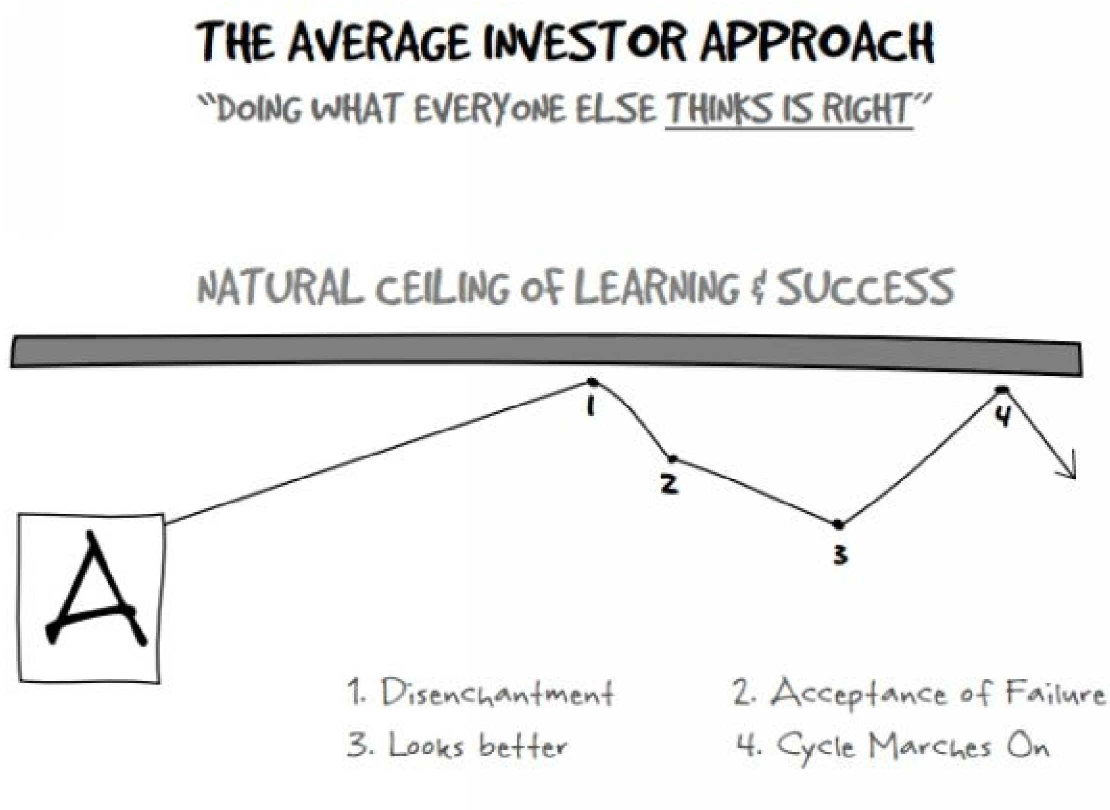


FIG: 4 Learning Curve of Average Investors

While it can be easy to give up and move onto the next “shiny” object, the top investors will keep learning, and run through levels. They will reach areas and levels of understanding that they didn’t even know existed.

We like to call it, *The Endless Rise Investor Approach* to investing. It’s how we came up with the name for our entire mission of empowering investors. As well as helping individuals invest better with access to better ideas and opportunities.

All too often investors become overwhelmed with the mountains of information being thrown at them on a daily basis. By focusing on the select few elements that matter most to investing success, an investor gains an edge over the rest of the market. This, in turn, will allow you to reach levels you never before imagined.

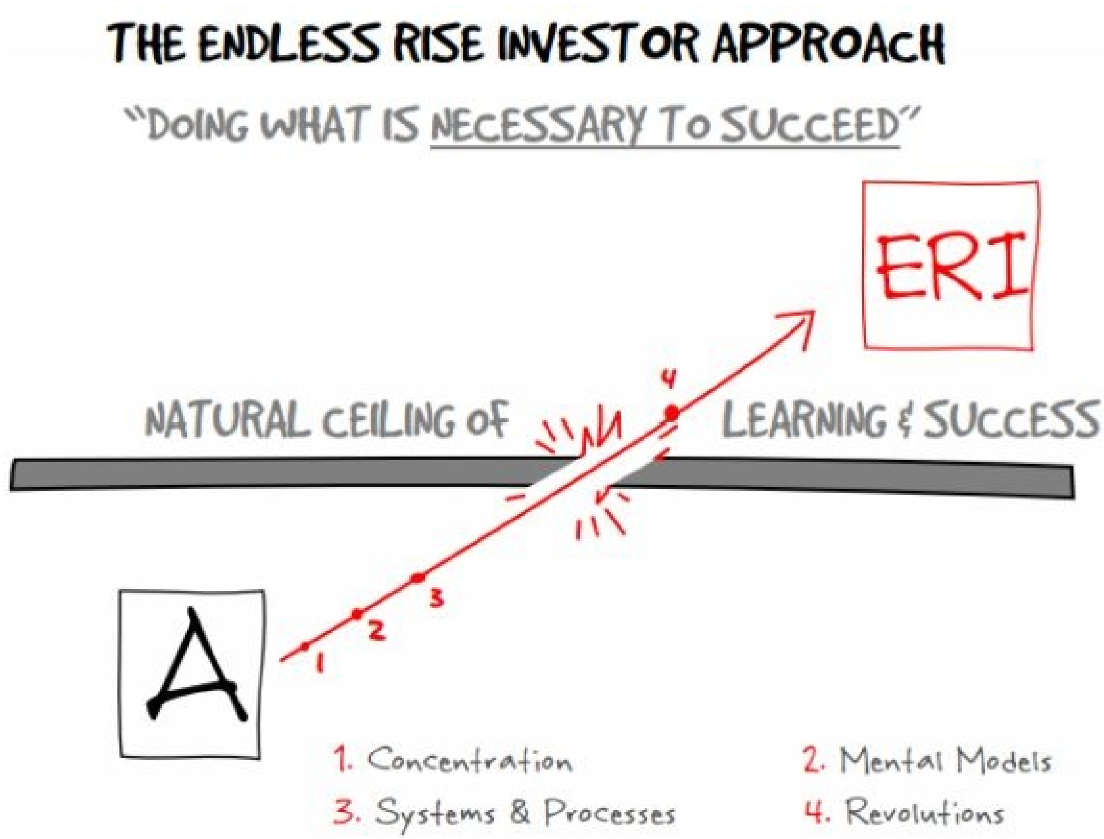


FIG: 5 Learning Curve of Endless Rise Investors

Once you understand the 5M™ Mental Model, and can efficiently analyze companies using The MECOM™ Method and Margin of Safety sections, you will allow your mind to enter this state of flow as you start investing and researching businesses. Then the sky is the limit.

This is the very idea behind The MECOM™ Method.

It allows the mind to enter a hyper-state of analytical flow by showing the investor which factors to concentrate on the most. Visualizing how great investment ideas should look and the process of investing, accesses both sides of the brain.

Thus, MECOM™ allows for whole-brain investing.

It allows for visualization, as well as action.

Through whole-brain investing, MECOM™ offers a far superior method to successful investing.

With this focused attention on the most important components to investing success, you will allow yourself to enter a state of flow.

Investing As A Leisure Activity

"…If you can buy a few great companies, then you can sit on your ass. That's a good thing."
Charlie Munger

There's no escape.

The thought of investing is constantly on the minds of most individuals as they search for ways to boost their wealth.

The issue that most investors face is that they don't know how to properly approach it.

When it comes to investing in the stock market, most individuals watch the movement of the numbers and the data with a feverish regularity. Many see their efforts in the stock market as a business that must be monitored regularly, "tick-by-tick." They constantly watch for perceived "tell-tale" signs of when they should buy or sell, in hopes of gaining outsized returns through activity.

The problem is activity doesn't mean success. In fact, it's quite the opposite.

There's no question that the trickiest part of investing is choosing the right approach and the right system. Even the most seasoned of investors will, at some point, find that their investment choices will not perform as anticipated. This can cause them to become more active in hopes of looking busy or providing value.

Investing is not a static exercise. Achieving investment success isn’t just about making one right choice. Not only do you need to make the right choice in your investments, you also need to exercise such qualities as patience and composure.

So successful investing is not only choosing the right investment, but also waiting for the right investment and holding on to it.

Instead of being on a constant search for stocks that may or may not produce results, an investor should, instead, patiently wait for that one stock that promises to deliver profitable results over its lifetime. These investment opportunities must meet a very specific set of parameters in order to make the grade, and therefore, may be few and far between.

We discuss this more in section 4 of this book: the MECOM™ Method.

As a leisure investor, you want to understand how a potential business actually fits in relation to the rest of the world or an industry. Looking for this unique perspective could give you some insight that others may not be able to glean from just studying a company's specific fundamentals.

When you're analyzing a particular stock you want to make sure that it has some type of moat (sustainable competitive advantage) that will make it harder, if not impossible, for competitors to swoop in and take over a percentage of the market share. You're looking for a deep moat that continues to get deeper as the business continues to grow.

This will allow your investment to compound in a leisurely manner.

Great stock opportunities do not come along every day, so you have to keep on the lookout for them and add them to your watch-list when they do come along. Sometimes it may take years for that right pitch to come along, so patience is key when it comes to making the right decision.

This phenomenon always reminds me of a quote by the great algebraist Jacobi Pascal, "All man's miseries stem from his inability to sit in a room alone and do nothing."

In short, don’t be busy for the sake of being busy. Doing nothing is a conscience choice too.

You need to resist the need to trade or transact every quarter just to make sure you're looking busy. Instead, it is better to simply lead a relaxed and leisurely lifestyle while maintaining your watch-list until that perfect opportunity comes along.

You have the best analysts in the world at your fingertips.

Use them!

Historically speaking, the pioneers of any venture often take the arrows. The same goes for investing and researching great ideas. You actually increase your level of risk by trying something new.

There is great news though.

Hedge funds and institutional funds are legally obliged to report their end-of-the-quarter holdings with a 45 day delay. This filing is called a 13F filing.

We are able to see fund position on a more real-time basis through 13G and 13D filings. 13G filings must be filed if they accumulate more than 5% of the business, and 13D filings must be filed if they accumulate more than 10% of the business.

The goal with these filings is to find “long-term” and “focused” value investors. Understand their philosophy and make sure they are long-term investors, and not likely to trade in and out of the market every quarter.

Once you find investors that fit your philosophy, you want to focus on the top 10 positions in that manager’s portfolio.

We focus on the top 10 positions for 2 reasons:

1) The top 10 positions will drive the majority of the gains in their portfolio.
2) Managers focus their best ideas in their top 10 positions.

There is no reason to focus on a manager’s 20th or 50th best idea. If a manager has a great idea, he/she will give a higher weight to that idea in their portfolio. They essentially tell you which stocks to pay attention to.

There you have it!

You have the best investment managers and analysts working for you under one roof and you don’t have to pay them a dime.

How great is that?

How’s that for a nice little shortcut in finding great investment ideas?

This strategy alone will pay for itself in time and money. It will save you months, if not years, of research finding high-quality businesses. I wish I had used this strategy earlier. I could have spent more time at the beach.

There is one caveat, but it doesn’t really concern us too much because we aren’t blindly rushing into any investment that these fund managers make.

We only see their holdings on a quarterly basis with a 45 day delay, so it’s possible for investment managers to buy and sell stock before you even have a chance to act. The position could even be a hedge against another position.

There could be a number of reasons why a fund manager is holding a stock. That is why you need to know which managers to follow. As important as it is to find the right investment managers to follow, it is equally, if not more, important to know which managers to stay away from.

Many skeptics will state that by the time you have access to the information it is too late to piggyback off the investment managers.

This would be true if we focused on hedge funds or active funds that trade in and out of securities on a regular basis. It would also be true that we could be hurt by blindly following them into their stock ideas, but we also do our own homework. We never blindly follow anyone into anything. That's not an investor.

As a result, we stay away from those active fund managers. Over the years, I have compiled a list of the longer-term managers. Obviously this is not set in stone, and managers are subject to buy and sell any security at any time.

However, I have followed and researched these managers for over 10 years, and this is a list of mangers that are focused, long-term investors. Sometimes they take years to build a full position. This is the kind of long-term philosophy we want to pay attention too.

- Warren Buffett (Berkshire Hathaway)
- Charlie Munger (Berkshire Hathaway)
- Ted Weschler (Berkshire Hathaway)
- Todd Combs (Berkshire Hathaway)
- Monish Pabrai (Pabrai Funds)
- Mason Hawkins (Southeastern)
- Bruce Berkowitz (Fairholme Funds)
- Bill Ackman (Pershing Square)
- David Einhorn (Greenlight Capital)
- Jeff Ubben (ValueAct)
- Chris Hohn (Children's Investment Fund)
- Leon Cooperman (Omega)
- Seth Klarman (Baupost Group)
- Eddie Lampert (ESL Investments)
- Dan Loeb (Third Point)
- Carl Icahn (Icahn Enterprises)
- Guy Spier (Aquamarine Fund)
- Michael Price (MFP)
- Wilbur Ross (WL Ross & Co)
- Whitney Tilson (Kase Capital)
- Donald Smith (Donald Smith & Co)

How’s that for an All-Star analyst team?

This is not an all-inclusive list of great stock pickers; however, this should be a great starting point for any investor to find great investment ideas.

Feel free to add or subtract to this list over time as you build your watch-list.

REMEMBER: the goal of this strategy is find high quality investment ideas. You should never blindly follow anyone into an investment without doing your own homework.

That being said, it’s still a great place to start.

Where do I find them?

www.GuruFocus.com
www.InsiderMonkey.com
www.MarketFolly.com
www.EndlessRiseInvestor.com

Always Have a Checklist

Over the years, we have learned many valuable lessons on how to find the best possible investment options.

However, we did not come to that knowledge without making a few mistakes along the way. Even after you've done all the research and analyzed every possible angle you can think of, things can still turn sour. Lessons are to be learned at every turn, and those that lead to losses will remain with you for many years.

The trick is to take those lessons and avoid repeating them. You can do this by maintaining a checklist that will eliminate the risk of forgetting to check for certain circumstances that could lead you down the wrong path.

Our simple MECOM™ Method checklist consists of about 27 different items (broad based). *Click here to access a checklist of the MECOM™ Method.*

When you study your list, you will be able to compare it to other factors in your portfolio and determine what risk factors you would be exposed to. Realistically, any business you choose will have some element of risk, but it will be up to you to decide what percentage of risk you're willing to take based on your checklist and other available opportunities.

Investing in the stock market is not for the faint of heart. It can be quite frightening to put your hard-earned money at risk.

However, you'll soon realize that taking some very basic steps can yield some very positive results. There is no need to put all your money into your investment ideas all at once. It's not complicated, but by applying simple logical measures, your chances for success can be amplified.

When you trust your natural instincts and avoid letting your emotions get in the way of analyzing your investment choices, you'll know the great investments from the mediocre ones. At the end of this book you will have top knowledge to build on and compound, which will serve you well over the years.

Playing Within the Lines

Staying away from inside information is another reason for investing as a leisure activity.

When you are entrenched in the financial world, there will be times when the lines of legality or conflicts-of-interest become blurred.

By being independent and being out of the influence of Wall Street, you can set yourself apart from the crowd. This is another reason I have chosen to invest outside of Wall Street.

Not only does it limit distractions but I never have to worry about the line of legality by mingling and having personal conversations with top executives.

Of course without inside information, you will have less information. Between the two options, I prefer investing with less information because I know I won't allow myself to be anywhere near that ethical sideline. I believe that an investor should always take the extra step in staying within the field of the law.

Seth Klarman, manager of $24 billion Baupost Group, says “If you play near the sidelines, you might stray out of bounds or someone might think that you did,” he wrote. “We strive to play in the center of the field.”

He calls it the "Football Field Test."

Whatever your decision, you would be well served to always stray from running out of bounds. Play in the middle of the field; if you run a properly executed play it is the quickest and shortest distance to the end-zone.

Always Have A Watch-list

Your watch-list is a critical component of a leisure investor.

By accumulating high quality businesses in your watch-list, and constantly maintaining them over time, you will be prepared when the market presents an opportunity to invest in a business on your watch-list.

Personally, I have developed two proprietary watch-lists over the last 10 years of researching businesses: a high quality business watch-list and a special situation watch-list.

If All Else Fails…

Use low-cost Index Funds.

Yes, I said it.

If you don't have the adequate time or energy to give a few hours per week or per month to investing, then this is probably your best option.

I would rather you be invested in the general market because I believe you will earn a satisfactory return over time.

The world in general will continue to grow and produce more and more goods and services. I believe the U.S. will continue to be a leader because of its structure and rule of law, but that's for you to decide.

Either way, investing in low-cost index funds is better than earning nothing at all. It is likely that this investment vehicle should yield a reasonable return over time if you add a certain amount from your pay check every month. Even if you find investing difficult, there's no reason to be left behind.

BOTTOM LINE: With regular investments of a steady percentage of your income into index funds every month, wealth is bound to follow 20, 30, or 40 years into the future.

All you need to do is put away 5% of your income every month into one or two low-cost index funds. Essentially, that's all you'd have to do.

Since many active managers consistently under-perform the indexes, the odds of you, as an individual investor, making a significant return on your investment are high. Statistics show that only one in 200 managers have successfully outperformed the index by more than 3% every year.

Vanguard is the gold standard of low-cost index funds.

Having an equal mix of the S&P and Russell funds would make a good mix. Starting early on in your 20s and investing 5%, 10%, or 15% of your monthly income into these funds would eliminate the need to go into bonds and other forms of investing. The returns should make it well worth your while.

Although I would be considered a "stock picker," the numbers speak for themselves. A low-cost index fund strategy is surely a way for the average investor to participate in stock market gains with extremely little investment of time or effort.

Just make sure to give yourself room to add to your positions over time. Never buy too much during times of euphoria, and never sell everything when all around you seems to be falling apart.

Because so much capital is tied up in the hands of Hedge Funds and Mutual Funds, high quality large cap stocks are usually incredibly overvalued. Usually the good stuff is too expensive.

Unfortunately, this is not conducive to leisure investing, so an investor must be very patient over the long-term to wait for opportunities, and events that we discussed earlier.

If you fashion yourself a long-term investor, and want to learn more about the ideas we send value investors and institutional firms, please check out the special limited time access below.

The point of this book is help you become a better investor through the methods and philosophies of great investors. This special LIFETIME access is here to help you get started on the path to finding great investment ideas and opportunities right now.

As a gift from me to you, to help you invest leisurely: I want to give you LIFETIME access to *Guru Investor Edge*.

Get your Lifetime Access now at this hidden link:

https://GuruInvestorEdge.com/LifetimeAccess

How incredible is that?

Invest Leisurely.

Approach Investing Like A "Real" Business Person

"Investment is most intelligent when it is most businesslike."
Benjamin Graham

There is a common misconception that entrepreneurs and business people are risk takers.

Not so fast!

Contrary to popular belief, entrepreneurs are not major risk takers. In fact, it may come as a surprise to many, that most successful entrepreneurs are incredibly risk-averse.

When it comes to building a business, they do everything within their power to reduce the level of risk they expose themselves to. A closer view of some of the major entrepreneurs of our time will reveal that taking "high-risks" was NEVER a part of their strategy when they began their businesses.

For example, Ray Kroc of the McDonald's enterprise, and Herb Schultz of Starbucks, both had minimal investment risk but they were able to yield exceptionally high-returns just the same.

Even Bill Gates invested only $50,000 to get Microsoft off the ground. That was the total amount of capital put into the company, certainly a low risk / high reward venture. As we know, it turned out quite well for Bill.

Of course, his investment could have gone either way. He could have gone completely bankrupt or he could have become extremely wealthy; however, his level of risk was extremely small in comparison with his potential rate of return.

Gates knew the probabilities, and he knew the risk-reward profile (Kelly Formula at its finest). Even if he failed initially, I would venture to guess that he would have made the same decision every day of the week.

BOTTOM LINE: Gates did not invest a portion of his wealth that he was uncomfortable investing. Investing is inherently risky; anything could happen at any moment.

What separates the great investors from the mediocre ones, is the ability to correctly perform basic math and probability. And then using those basic probabilities in different scenarios and situations (stress test). Gates was more than willing to take on the uncertainty that came with investing in a new venture because of the low risk-high reward-high probability profile of Microsoft.

If you take care of the downside, the upside will take care of itself.

A business person is constantly evaluating the risks and probabilities of those risks. They want to know all the possible ways they could lose money and how to minimize those risks.

Understanding the unique downsides to any business venture is similar in terms of how you analyze your risk investing in stocks.

You want to focus as best you can on how you can negate or shield yourself from risk.

It’s essential to your future success.

Commitment and Perseverance To Succeed Long-Term

"Unless you can watch your stock holding decline by 50% without becoming panic-stricken, you should not be in the stock market."
Warren Buffett

If you don't know something you need to know, then go out and learn it!

If you don't know how to do something that you want to do, then go out and do it!

There is no obstacle too big.

I listen to objections and concerns from many customers, and many colleagues, that prevent them from achieving investing success:

- *"But I don't know how to invest."*
- *"But I don't have a brokerage account."*
- *"But I don't have time to be a good investor."*
- *"But I don't know how to calculate a company's free cash flow."*
- *"But I don't know how to figure out if a company has a moat or not."*
- *"But I don't have any investing background."*
- *"But I don't have any investment materials."*
- *"But I don't know where to even start."*
- *"But I don't have enough money."*

When I hear these questions sometimes, I am shocked.

I think to myself, "What's going on here?"

First, I offer all of this information within our books, as well as our training materials and methods at EndlessRiseInvestor.com.

Second, and more importantly, no one knows anything right away.

You have to go out and learn it. You have to struggle a little and keep moving forward. 5M™ is a great first step in learning a simple, proven, repeatable system for achieving success.

In life, just like investing, there may be days when you want to quit or give-up. There may be days when I let people down or people let me down.

Trust me there were a few days when I wanted to reenact scenes from the movie Office Space. You know...calmly disconnecting all the cords from my computer and politely dropping it out of a three-story window.

You may feel alone at times; value investing in particular can do this to you.

In these moments it is essential that you think about why you are investing in the first place?

Imagine it’s one of two reasons:

1) To accumulate wealth and produce passive income for your retirement.

2) To accumulate wealth and produce passive income for yourself and/or your family. To put yourself and your family in a better position than they are in right now.

This should be all the motivation you need to keep pushing forward.

Always keep in mind that investing could change your life and your family's life someday. If you keep persevering, and if you keep learning, you will be rewarded in the end.

Here is a simple blueprint for wealth generation:

1) Strive to be the best at what you do;
2) Save by spending less than you earn;
3) Invest in High Quality Businesses for the long-term;
4) REPEAT

IT REALLY IS THAT SIMPLE.

You’ll be shocked how quickly your wealth will grow when you follow this simple step-by-step blueprint.

A Prosperity Mindset.

Whether we like it or not, our brain is wired to prevent wealth.

That's right -- thousands of years of evolution has hard-wired our brains to act (or react) to certain situations in certain ways. Unfortunately, many of these reactions are counterintuitive to our goal of achieving wealth and prosperity through investing.

However, there’s good news…

There is something we can do about it!

By arming and educating ourselves about our genetic predispositions, we can combat the negative feedback loops and psychological biases that try to hold us back in life.

Surely, this will not be a “one-size-fits-all” approach or a quick fix. It will take years to master your mindset, and counter your negative psychological tendencies.

However, merely being aware of our negative biases can help keep us from making undue mistakes in our pursuit of prosperity.

Just having awareness and knowledge about these biases can make a huge difference in your financial world. It’s so important because it can be the difference between success and failure.

Prosperity is not a state of financial well-being; it’s a state of mind. But in order to be successful and run through the barriers of life and investing, you need to arm yourself with this prosperous mindset.

It’s an attitude about how you approach life.

Guy Spier (Aquamarine Fund) talks about this a great deal in how he approaches life. Despite his incredible proclivity for enormous humility, he’s an amazingly brilliant person. He’s more than generous with his time, and genuinely cares for others around him. It’s very rare in the world (especially the financial world).

He discusses a book, “A Simple Act of Gratitude,“ that had a tremendous impact on his life. After reading it, he was so excited by the notion that he started handing out gifts to random people, like the door-man. He would also write 3 thank you notes five days a week to people that had touched his life. He even credits his thank you note to Mohnish Pabrai for helping develop their relationship.

I remember first reading about Guy in the Manual of Ideas July 2012 issue, which is when I first heard him discuss the book, and how it had changed his life. In the transcript he said anyone reading this should contact him, and he would send them a copy of the book.

I could've easily ordered the book, but I wanted to see what he would do. So I sent him a message. Lo and behold a package arrived at my door two weeks later with a thank you note and the book.

I was amazed. He had no idea who I was, but he was more than willing to help another human being out. It speaks wonders for his character, and the kind of person he is. How incredible was that?

BOTTOM LINE: Being nice to people, doing the right thing, and providing value to peoples' lives will ALWAYS pay the biggest dividends. As Guy says, "so much of what's good in my life is from the compounding of human goodwill."

This prosperity mindset will focus you on positivity and pushing forward, no matter the obstacle. Most people think of investing as a mind-numbing procedure that takes place behind the scenes of normal daily life. Although it can be tedious at times, investing is one of the most worthwhile skills to learn as an individual because of its dynamics.

It's essential to you and your family's future wealth. It's important to put aside a little time each day or each week to look at your investments. And really understand the underlying fundamentals.

Most individuals compare long-term investing to watching grass grow.

But <u>have you ever seen how fast grass grows?</u>

The first step in achieving investment success is BELIEVING.

Contrary to popular opinion, believing you can do something is actually the first step to achieving it. This first step is often overlooked by the majority of individual investors.

We end up with so much stress in our lives because we don't pay attention to our mindset.

There is great news though; creating a prosperity mindset can be achieved quickly and easily with a little work and perseverance.

Having a Prosperity Mindset means not focusing on things that YOU don't have or things that YOU can't afford to purchase. The Prosperity Mindset does not allow us to be envious of other people because there is so much prosperity in the world for YOU to capture.

If you focus on the things you don't or can't have, you have a scarcity mentality. And there is nothing more detrimental to your overall well-being than a scarcity mindset.

As Charlie Munger says, "There is nothing more counterproductive than envy. Someone in the world will always be better than you. Of all the sins, envy is easily the worst, because you can't even have any fun with it. It's a total net loss."

I love that quote. It makes me laugh every time.

Does any of this describe your general attitude towards life?

If so, don't worry.

I had the same kind of mindset. It's actually quite common. This is not the mentality we want when we are trying to acquire wealth and invest in businesses, which is why we are going to change your mindset right now.

You **ONLY** need **2 THINGS**:

1) A willingness to <u>approach your life in a different way</u>.
2) The courage to <u>take action with your new approach to life</u>.

This is not an all or nothing transformation. This is something that will take place over time. So you need to approach it day by day to make sure you are taking the right steps.

There is no reason to feel overwhelmed because I have even more GREAT news for you...I will be here to help along your journey!

Perhaps you look at situations differently. You see something and think something bad right away, or maybe you worry about the bills stacking up or not having enough for retirement.

Whenever you feel the burden of life or investing, I want you to write down on a piece of paper these 6 words:

What's the worst that could happen?

Be truthful now.

I want you to really write all the bad things that are happening in your life, after you write down, "What's the worst that could happen?"

I am willing to bet that things aren't as bad or impossible as you first imagined.

Now I want you to think about and write down all the prosperity and abundance in the world. I want you to think about how you can position yourself in that prosperity and abundance:

- Be grateful for the things you have right now!
- Be optimistic of the wealth you will accumulate over time!

- Be optimistic of your future success!
- Be more than what you are right now!

I believe in YOU! It’s important that you develop this Prosperity Mindset so you can believe in yourself too.

In developing a prosperity mindset, it’s important to align your perception of wealth with your attraction to it. This means you cannot have negative opinions towards wealth or wealthy individuals and hope to be wealthy yourself.

It stacks the deck against you.

First, it really isn't nice or logical to have negative opinions towards anyone (of course we all do at times).

Second, people tend to get what they deserve over a long period of time.

Admire people that have come from nothing to be millionaires or billionaires. Take note of their stories and methods in how they achieved such great success. Clone them!

Trust me…Success leaves clues.

Meet them, read about them, try to interview them, and learn as much as you can from them. The more you do this, the more you will realize what it takes to be successful as an investor, as well as an individual.

While changing your mindset from scarcity to prosperity, you need to turn your attention away from people, thoughts or situations that do not promote your newfound prosperity mindset.

Think about it: what’s the ratio of nice stories compared to horror stories on the news?

Why do humans focus so much on negative news?

The news media even has a saying, “if it bleeds, it leads.”

They know that horror or fear monger stories hit at our very core. It gets our attention every time, so it can be very difficult to turn off.

You do not want to obsess about problems and challenges. And this doesn’t mean turn a blind-eye either; always be aware of the problems and issues, and acknowledge them.

You always want to be aware of the problems, but wallowing in these problems and challenges is not productive to our family or our society. If you allow yourself to enter a scarcity mindset, you subconsciously allow yourself to be focused on things that make you feel powerless.

You must train your mind to acknowledge problems and challenges, and then turn your focus back to prosperity and how to fix them to keep moving forward.

Once again, this does not mean you lose all sense of reality.

You still need to pay your bills, your student loans, your mortgage and you still need to be conservative in your valuation of businesses. The prosperity mindset does not mean you abandon all responsibilities; it just means you need to stop obsessing over your negative problems and challenges so you can work to finding solutions.

Anytime you feel yourself losing control you need to start asking yourself the right questions:

What can I learn from this?

How can I improve the situation in a positive manner?

What's the worst that can happen?

How do I come up with a solution to the problem?

It’s so important to be proactive in defeating this scarcity mindset. We shouldn’t spend hours worrying about things that are unproductive; it’s a waste of time.

These things include: wallowing in self-pity, being envious of other people, worrying about money and finance, and not taking action because of fear of failure.

Don't focus on where you are, focus on where you want to go and how you’ll get there!

The Prosperity Mindset does not allow for negative thoughts or situations to take over your life. We know they exist. We are aware of the dangers and risks in the world.

The difference is---we welcome these situations as opportunity!

Stay prosperous my friend.

In this chapter, you learned how to enter into a state of flow, how to invest as a leisure activity, how to approach investing as a ‘real’ business person, how to show commitment and perseverance in your investing and how to use a prosperity mindset.

In the next chapter we will learn how to Master Your Investment Morals (philosophy).

PART 3: MORALS MASTERY

Do You Have The Proper Philosophy?

"To educate a man in mind and not in morals is to educate a menace to society."
Theodore Roosevelt

It was mid-2009, just after the near collapse of the stock market. Businesses were beginning to rebound but the entire market was still jittery. That included me.

I was just put in charge of managing a portfolio for the first time. I had never seen a portfolio go down by 50% before. Even though I knew each of the businesses in the portfolio were of high quality, I still had this devil on my shoulder telling me to "sell something during this suckers rally. The market will just crash again."

I had identified the business as having numerous competitive advantages in the form of an ecosystem, extreme brand loyalty, supply chain advantages, and growing in free cash flow at over 30% per year. The returns on invested capital were very impressive, and the business had free cash flow yield at over 10% for a business growing rapidly.

The company had a runway to growth through a pipeline of new products, as well as likely increases in its subscriber base through iTunes and office space integration with desktops and tablets. They had no debt and lots of cash on the balance sheet. Management at the time was the most innovative and creative team on the planet with a record for being stewards of shareholder capital.

I started purchasing all the way up until 2008. Then I became shell-shocked as the market begun to crash. Instead of purchasing more in a business I knew to be one of the best in the world, I sat on my hands. Not only did I do that, but I also sold the entire position at a big loss as soon as the stock started to rally off the lows in 2009.

Of course we know the story here: Apple continued its trajectory upwards as it increased more than 5 times off its lows in 2009. See figure 6 below of my buy/sell decisions, and the missed opportunity. It's still the worst loss (and lost opportunity) of my career, and it happened because I didn't have the right mental models in place to keep me grounded and focused on the task at hand.

All my analysis on this business went out the window.

FIG: 6 Apple (AAPL) Missed Opportunity. 2007-2015

I allowed myself to become overwhelmed by the stock price instead of the factors that really drive the business: valuation, free cash flow, growth, underlying business fundamentals. I had no plan, and I did not have a sound process. It’s the main reason I failed early on in investing.

In the last section, we explained the mastery of your mindset in investing, and how it provides a base for your investing psychology and behaviors.

Since you now have Mastery of the Market and of your Mindset, next we will dive into detail on Mastery of Your Morals.

In this section, we will learn how to Master Your Investment Philosophy.

By the end of this section you will be able to:

- Think about risk before return,
- Approach investing with a contrarian streak,
- Stick with a long-term approach to investing,
- Use the “few, big and infrequent bets” method for investing, and
- Understand that the underlying businesses will dictate investment, not the macro picture.

Morals are defined as “a person's standard of behavior or beliefs concerning what is and what’s not acceptable for them to do.”

These are not the kind of morals that your mother or father taught you growing up. When we talk about your morals in this book, we are referring to YOUR INVESTMENT MORALS.

Essentially this is your investment philosophy and how you view investing. Your philosophy will keep on point during the good times, as well as the bad. So try to think of them as your morals because they ARE that important to your investing success.

Your morals are something you would never abandon because they make you who you are. Thus, your investment philosophy should become engrained into your thought process because it will become a part of your investment toolbox and system.

Just like your mindset, you use your investment morals subconsciously while you are making decisions. You never know when you may need each one, but

it’s imperative that you learn them and ingrain them in your mind now because you could need them at any moment.
As long as the world exists, there will always be a need to understand investing. History is packed full of fascinating and worldly knowledge that is just waiting to be plucked by someone who wants to learn.
TODAY that someone is you.
Take a look at the figure below (fig 7). It shows my thought process on buying and selling decisions now (part of my morals). This figure is by no means set in stone. I am a very visual person, so having this hanging in my office is a daily reminder to stick to my system.

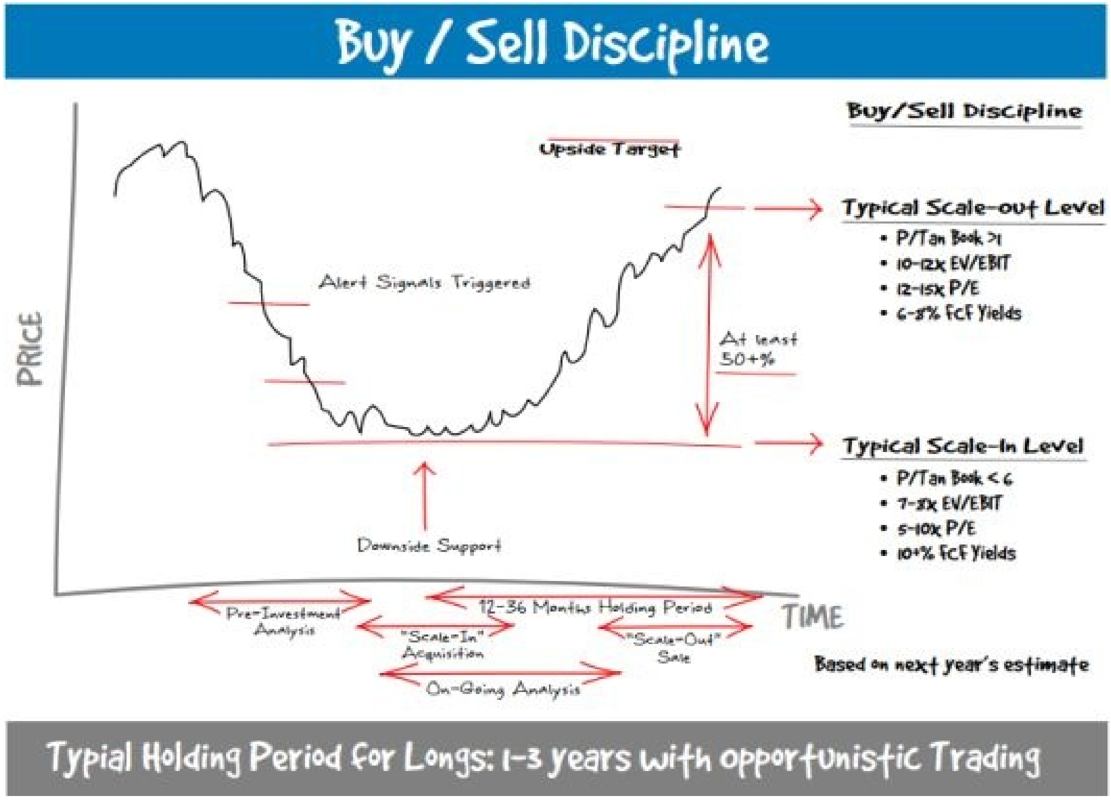


FIG: 7 Buy/Sell Discipline

Always Think About Risk before Return

"Focus on the downside, and the upside will take care of itself."
Mark Sellers

Every great investor has one thing in common:

They think about risk before ever contemplating return.

Contrary to popular opinion, the greatest investors are extremely risk-averse. A great investor will always focus on risk first --- reward second. The majority of investment strategies and systems do not focus enough on risk and the probability of permanent capital loss. I only know of one such strategy, and that's value investing.

There are only a few options you can use to help you decrease your risk: hedge or sell when appropriate, know your investment intimately, hold cash, invest in the "risk-free" rate, diversify to a certain extent, and of course invest with a margin of safety.

GOLDEN RULE: DON'T LOSE MONEY

1st Rule of Investing: Don't lose money.

2nd Rule of Investing: Don't forget the 1st Rule.

As many know, this statement was made famous by Warren Buffett, and I agree with him wholeheartedly. This is why I believe that investing in a risk averse manner is the best way to protect your capital and increase your wealth over the long-term.

Any permanent losses to your investments can wreak havoc on the beauty of compounding. Even compounding at very low rates can bring about massive success, so an investor's focus should be on understanding the potential for permanent loss in any investment.

Of course this doesn't mean you never incur risk.

First, we need to define risk. The definition of risk is an interesting topic altogether, but I define risk as the probability of permanent capital loss over several years. Fluctuations in stock prices do not constitute risk. The underlying business fundamentals, and its future prospects will determine what constitutes risk.

"Risk comes from not know what you're doing."
Warren Buffett

There is no hard-fast rule on how to eliminate risk completely. This is why the best way to mitigate risk is through an appreciable (and expanding) Margin of Safety. We discuss this in greater detail in section 5.

We're all human. There is a speculative urge encapsulated in all of us.

The first step is to acknowledge it, and then move on to making unemotional and rational decisions. The idea of quick and easy money can sometimes be too difficult to pass up, but we must resist the urge. Speculative situations give market participants the greatest probability of risk.

It may sound counter-intuitive; however, avoiding risk at all costs is the best way to produce wealth over the long term. This is why we focus on the business fundamentals and a margin of safety.

There will be many times throughout your investing journey when you will be tempted by speculative ideas. Don't give in to the temptation. The market wants you to make these impulsive and speculative decisions.

Always search for free cash flow and protection in the form of assets. To decrease your risk in any investment, always insist on a margin of safety.

It's funny to me that the majority of investors think they need to incur significant risk to attain significant returns. If you are able to mitigate your losses, and compound your money steadily over time, your returns WILL be significant.

This brings us to another important topic.

Volatility ≠ Risk

Volatility is opportunity to a value investor! Not risk.

In fact, we welcome volatility. However painful it may be in the short run, we know that it allows us to establish positions in high quality businesses or special situation opportunities that offer the highest probability of success.

Our view is that the market and its individual components are not efficiently priced ALL the time. Now realize I said, "Not all the time." We are not believers in efficient market hypothesis (EMH), but we do believe the market does a fairly good job of valuing securities most of the time.

Our main issue with EMH is that it ignores tail risks and uncertain or unforeseen events. History has proven repeatedly that you need to be prepared

for the unknown. As a result, you need to expect the unexpected. And actually prepare to be wrong. This is why you want to position your portfolio in such a conservative manner. Value investors know they will eventually be wrong.
These times of uncertainty are welcomed. When the market over reacts to the upside or downside, it can create opportunities for long-term value investors to take advantage of in a risk averse manner.

A Contrarian Streak…

"Value investing is at its core the marriage of a contrarian streak and a calculator."
Seth Klarman

Focus on the future productivity of the business you are investing in, what's happening right now at this very moment in time.

Try to take a step back and see the bigger picture.

Obviously you can't predict the future, but carelessly extrapolating current trends into the future is a recipe for disaster. Both on the upside and the downside. The market is most dangerous when market participants lean too far in one direction. This can set up important inflection points in overall investor psychology.

Having a contrarian streak comes with a major caveat: don't be contrarian just for the sake of being contrarian.

Investors know that a major factor to investing success is the ability to go where others will not. That's where an investor will be able to achieve excess returns versus the overall market, if executed properly. However, the concept of contrarianism can be taken to extremes at times.

REMEMBER: The market is right 90% of the time.

Also, we don't want to be too negative all the time. The U.S. and global economies are likely to produce more goods and services over the next 50-100 years.

And of course, there will be corrections along the way, but I don't want to get in the way of that freight train by being too negative or contrarian all the time.

With that said, great investors have streaks of being a contrarian. This means you must be willing to take the other side when you feel sentiment and fundamentals have swung to an extreme.

As the market rises and enters a euphoric phase based on soft fundamental principles, you must be willing to sell or trim positions if the market becomes too frothy. Think of the tech bubble of 2000 or the housing bubble of 2007.

Ultimately, you want to be “buy and hold forever” type investors, but there will be times when the market becomes highly irrational. If you are right about the businesses you invest in, even bear markets will not dislodge the growth of the business.

During these situations, it can still be a prudent action to alter your portfolio by increasing cash positions or hedging your current positions. There have been times when I have gone to 50% stocks and 50% cash when I think the market is overly optimistic about the future.

Conversely, when the market enters a depressed phase based on panic and fear, you must be willing to buy with both hands. These are the times that provide the greatest chance of outperformance.

It can be a very difficult endeavor to act counter to the overall market or sentiment. After all, it’s against our genetic makeup to run counter to the herd.

Undervalued securities are almost never popular at the time of investment. They are certain to be out-of-favor and heavily scrutinized by the media and analysts as they rush to lower price and growth estimates that they were too optimistic about in the first place.

You want to always have the mindset of buying what others are selling and selling what others are buying.

When you pay attention to the activities of the crowd, it’s important to focus on the sentiment of the general market, as well as the fundamentals. It’s in these two areas where an investor can see the pendulum of rational thought swing to extremes. These are the inflection points we discussed earlier.

When the market is selling a security for irrational reasons, the selling can sometimes get to an extreme level beyond logic. This creates the undervalued opportunities that we search for on a regular basis.

You will always be wrong -- initially, that is.

The most difficult part of being contrarian is the FACT that you will be wrong when you first purchase your investment. Not only will you be wrong, but you won’t know when things will turn around.

This can have a devastating impact on your patience as a value investor, but we will prepare ourselves for that situation right now.

As an investor you will NEVER be completely certain if or when you will be proven correct. That’s why it is SO important to have a proven repeatable process to investing. It will keep you on the tracks when things get rocky.

BOTTOM LINE: Contrarians are almost always wrong initially as they suffer 'paper' losses. It's important to not let this dissuade you from staying on course and following your system.

Stick With A Long-Term Approach To Investing…

"If you are not willing to own a stock for 10 years, do not even think about owning it for 10 minutes."
Warren Buffett

The stock market is NOT a casino.

I have nothing against price speculation, but you must know the difference between investing for the future production capability of the business versus investing on the hope that the price will change over a short period of time.

It's for this reason that a distinction must be made: are you an investor or a speculator?

Focus on the long-term, not on the day-to-day movements of stock prices. Stock prices are only there to trick you into impulse buying and selling.

Knowing a business intimately and its future earnings potential will mean the difference between investing and speculating. Value investors have a longer time horizon than most. You could even call it "time arbitrage" if you'd like --- as the gap between current price and intrinsic value will close over time.

Mutual fund time frames are measured in quarters, while hedge funds are measured in months (some are in days). This provides a great amount of opportunity for the individual investor.

When value investors make a purchase, they always hope the price goes lower so they can purchase more.

This is where value investors deviate most from the mainstream investment world.

When I tell people that I hope the stock goes lower, they look at me like I am crazy.

But let me put it this way:

Imagine you were about to purchase the house of your dreams at a discount to its real value, and the owner drops the price by 20%, would you still purchase it?

Of course you would purchase it. You may be a little skeptical of the price drop, but if your due diligence finds nothing wrong, you just bought the house of your dreams for 20% less than you planned on.

Use the “Few, Big and Infrequent Bets” Method for Investing…

"You only need a few good ideas to make a significant difference in a lifetime."
Bruce Berkowitz

Over-diversification will lead to an average return over time.

As a result, I will gladly take short-term volatility for above-average return.

A focused portfolio helps keep you concentrated in your best ideas and it keeps you sharp. There is no reason to have more than 10 investments in your portfolio at one time, and certainly no more than 20. Anytime your portfolio gets closer to 20 positions you will start to mirror the indices.

In essence, they become unconscious closet indexers. And becoming a closet indexer is the death kneel of any great investor.

An investor is essentially saying, “I don’t know what to do” or “I don’t know where to put the bulk of my capital because I can’t distinguish my best ideas from the mediocre ones.”

Closet indexing is essentially “giving up” in investing terms.

Great investors don’t strive for mediocrity. This is the entire reason why we focus on our best ideas while diversifying appropriately.

Portfolio Management

Being a successful investor involves more than being a great stock picker and having a great temperament. The review of one's holdings, as well as proper and opportunistic trading, is vital to successful portfolio management. An investor’s job as portfolio manager includes: watching cash levels, diversifying properly, controlling the amount of positions in portfolio, and making buying-selling-hedging decisions.

Having a sound portfolio management understanding in conjunction with a value investment system provides the maximum potential for any investment portfolio. Having one without the other is akin to purchasing a Ferrari without the engine.

However, with the two working together in lock-step, the potential is incredible.

As investors, we are always on the lookout for businesses that will last the test of time. However, capitalism can be brutal to companies that do not maintain or expound upon their competitive advantages. Although, certain investments may only be in your portfolio for a finite period of time, portfolio management lasts forever. Therefore, it is very important to have a proper portfolio management system in place to help navigate the investment waters.

These are three main components of a great portfolio:

- Cash levels
- Concentrated
- Undervalued securities

Cash levels are very significant. Cash allows you to take advantage of opportunities as they present themselves. As mentioned earlier, I've been at cash levels of more than 50% during extreme bull markets. This is not uncommon for me. Typically I have about 10-20% of the portfolio in cash. During extreme bear markets sell-off it will be 0-5% as we put the cash to work by investing in our best ideas.

I know cash is not looked upon greatly in the investment community. However, cash gives you liquidity and helps to decrease opportunity costs when/if markets eventually correct. Cash becomes very valuable during these times.

Investing in undervalued securities at a significant discount to intrinsic value is the primary job in portfolio management. It's by far the most important responsibility of an investor.

The business fundamentals, as well as the price paid, will determine the future returns of an investor over time.

When to Buy?

Never feel forced to buy the position all at once.

Try to leave room to average down the initial purchase price of your investment.

It always depends on the situation, but a good rule of thumb is to ascertain the size of the position you want to accumulate.

Let's say you want to accumulate a 5% position in your portfolio with this investment. I would usually purchase a small amount initially (usually 2% of the portfolio).

If the stock price continued to drop and nothing has changed fundamentally, you will be more comfortable in purchasing more (maybe another 3% of the portfolio). This brings the total investment of your portfolio to a little under 5% with a greater margin of safety because you purchased at a lower price from intrinsic value.

If it was a great investment at a higher price, it's an even better investment at the lower price (all else being equal). You must learn to take advantage of these types of opportunities, however painful it may feel at the time.

The ability to average down in the price paid for your investment is a critical factor in trading and future returns that's not widely held by most money managers. Usually on Wall Street you hear that you should never add to a losing position. They will say things like, "averaging down is for amateurs."

I think this makes them sound like amateurs.

This statement has no bearing on the underlying fundamentals of the business. It projects linear thinking, as it is focused only on what they see in front of them -- the stock price.

First, rarely will the purchase of a security turn into profits instantly (even for traders). It takes time for an investment idea to be seen or understood by the market. If your analysis is correct, the company will trade towards its conservative estimate of intrinsic value.

Second, an investment actually becomes less risky the lower the price paid (all else being equal). This is a concept that escapes even the most seasoned investors.

If the underlying fundamentals of the business haven't changed, and you make an investment at a large discount from intrinsic value, wouldn't it be a better investment at a lower price?

Most market participants fail to see this logic because they are swayed by the short-term loss of the original position, and think the market is telling them they are wrong.

Fear and panic must be thrown out the window when you are purchasing stock in a business. If an investor decides to make an investment, he/she should resist the urge to purchase a full position to help combat the psychological biases to loss.

I want to reiterate this point because I think it's very important.

Imagine you decide to invest. And let's say you would like this business to comprise 10% of your portfolio. You believe it's a great business with enduring competitive advantages, and it's trading at a reasonable price.

It would not be best practice to purchase the entire 10% all at once on your initial investment. Instead, try purchasing a smaller position of say 5%.

If the stock trades lower, an investor will not be powerless in purchasing more of the stock at a lower price. Establishing partial positions changes an investor’s mindset instantly. By initially purchasing the partial position, an investor’s mind is more focused on opportunity of when and where to purchase more.

This is in direct contrast to the investor that purchases a full position instantly, only to see the stock move lower. This can lead to regret and fear. And this leads to an investor panicking from losses.

Investors that establish partial positions know they can purchase more at lower prices, which lowers their average cost per share. Thus, an investor is able to lower their risk and change their psychological biases. This is a very powerful tactic in purchasing securities. And one that is rarely talked about.

Of course, this scenario doesn’t exist in a vacuum. There are other situations that demand an investor’s attention.

Thinking about the two perspectives of purchasing a security that goes lower, or purchasing a security that goes higher, can give you great insight into whether you think the company is of great quality with enduring competitive advantages.

As a value investor, if you are willing to purchase more of a company as it goes lower in price, or if you are willing to purchase more of a company as it goes higher, can distinguish a decision from being an investment or speculation.

If a business is truly a great investment you should have no problem purchasing as the stock price goes lower, just as you should have no problem purchasing a stock if it goes higher, as long as it is trading at a significant discount from intrinsic value.

If you have an issue purchasing the stock of a business as it continues to drift lower, or higher, then you probably have no reason to make the investment in the first place. You would be better served to throw it away and move on to the next potential investment opportunity.

When To Sell?

This is a question that comes up quite frequently.

Value investors are usually very good at finding undervalued investments, but they have difficulty in knowing when to sell. This decision is made difficult by the fact that there is no exact number for the intrinsic value of a business. As an investor you have a range of potential values, but there is never a precise number. This makes the selling process even more difficult.

I believe there are two types of investments: long-term High Quality Moat Investments and long-term Active Value investments (special situations).

High quality investments are investments I plan to hold forever, but this doesn't always happen. Better ideas come along or the fundamentals can change.

With active value investments I always sell half of the position if it reaches 100% gain or is within the range of intrinsic value calculations. At this point I have essentially written my cost to zero and I am free to sell the other half of the position as I see fit.

Other than that, I have one universal rule when it comes to investing: at the right price, virtually any security can be sold. If an investment is overvalued and a better opportunity presents itself, I will sell the overvalued security.

It's that simple. Not easy, but simple.

Stop-loss orders are another way traders (and sometimes investors) try to control risk of stock price movement.

I learned the hard way that stop-losses do not decrease risk. Instead of purchasing more of a security you deem to be a great investment, you sell the stock because you are afraid of temporary stock price movements. The market doesn't know the value of that investment in the short-term.

When you use stop-losses, you become a captor to the market. You essentially put the market in control of your decision-making process. And we know we never want that.

As you can see, every sell decision is based on price versus underlying value of the business. The timing and execution of the sale depends on opportunities that are present at that time.

If a stock increased, and was still undervalued with no other opportunities present, it would make sense to hold your investment. If a stock were fairly or overvalued, while other opportunities were abundant everywhere, it would make sense to sell and purchase new opportunities.

Timing the Market

Trying to time the market is another issue investors run into.

Timing the market is a futile endeavor. The best one can do is try to buy when others are fearful, and sell when others are greedy. That's the extent of my market timing.

Think about it this way: You do the proper research on a business you want to invest in. The stock is trading at $7.00. The market is quite fearful over the prospects in the short-term because growth didn't come in as expected.

Your research shows you that the company has a strong recurring revenue stream that will be around for a long time. You think this company has few competitors and has the potential to be around for 30 years. It trades at 10x free cash flow and is significantly below its readily attainable liquidation value of $20.00.

Do you take a pass on investing in the company because you think the company might go down to $3.00? Or do you invest in the company right now?

Imagine this scenario: say you purchase the stock at $7.00 and the stock rallies to $12.00 in 6 months.

What do you do now? Do you sell the whole position? Do you sell some of the position? Or do you hold for the long term or at least till it reaches fair value?

Let's say you decide to sell the whole decision or partial position in hopes of purchasing it lower. This opens up a quandary that is common among almost every investor: trying to improve performance through trading an INVESTMENT. The urge can sometimes be too great to overcome.

So at this point you sell the security. How do you decide when to get back in? Do you get back in at $10.00, $8.00 or $6.00? What if it rallies to $15.00...do you buy again knowing that it is still undervalued (just not with the same margin of safety)?

Remember, you believe this business to be a viable long-term investment. Why are you trading it in the first place?

At this point we have just overly complicated the matter by trying to time the market, instead of letting it compound.

I have developed a simple philosophy:

- If I believe this to be a great business that I am confident will be around for a VERY long time, I hope to never sell. I also know this isn't always practical, so I will hold until the business fundamentals deteriorate or a better investment opportunity with much better business metrics and competitive advantages comes across my desk.
- If it's more of an active value (turnaround or liquidation) investment, then I will follow the rules from above for great businesses. The main difference is I will ALWAYS sell 50% of my position if it rises 100%. The rest of the position is sold at my discretion. This essentially gives me a free position to do as I please. We discuss the more in the Catalyst section of the MECOM Method in section 4.

There are times when it can be prudent to hedge or sell positions that are overvalued. However, investors are better served to invest in great businesses that can compound your money and investment over time.

The only time to sell a great investment is when you believe a better investment exists. Although investors do not focus on short-term trading, good trading decisions can mean the difference between success and failure. Whether I like it or not, investors have to trade sometimes as new or better opportunities are found.

Agnostic of the Macro Environment…

"In the 54 years (Charlie Munger and I) have worked together, we have never forgone an attractive purchase because of the macro or political environment, or the views of other people. In fact, these subjects never come up when we make decisions."
Warren Buffett

Personally, I have wasted countless hours trying to make sense of the macro picture. And I've also made very costly mistakes in the process.

Ultimately, the underlying business will tell you all you need to know. All an investor needs to do is pay attention to the businesses they follow.

Listening to macro or market predictions is a waste of time and energy.

Focus on what is most important to making an investment decision in a business:

- Sustainable competitive advantages,
- Produces excess and stable cash flow,
- Possesses readily ascertainable catalysts,
- A "fortress like" balance sheet,
- Capable and trustworthy managers, and
- Trades at a reasonable discount to its intrinsic value.

If a business exhibits all or most of these characteristics, what else do you need to know?

I know there's a lot of noise out there right now in the investing world. However, if a business exhibits all these characteristics, it's probably best to mute the TV (unless one of your favorite investors comes on), turn off the radio, and stop reading Seeking Alpha. It's probably time to buy regardless of the macro picture.

Where Are The Great Macro Investors?

There aren’t many consistently great macro investors that I can name off the top of my head.

Can you?

I can think of only three: Ray Dialo, George Soros, and John Burbank.

Even then, these three are highly contrarian, and have value investor mindsets, so I take these picks with a grain of salt.

On the contrary, I have named, and could continue to name countless other value investors that have outperformed the market over the long-term.

Just something to think about.

I have touched upon this already, but as we have learned, the stock market, as well as the general economy is a complex adaptive system.

Correctly applying predictions on what the economy will do IS an extremely difficult endeavor. An investor’s time is better spent researching individual business and looking for a divergence between perception and reality (price and value).

Macro (top-down) investors tend to be trend followers, not contrarians.

Thus, there is little margin of safety. Top-down investors tend to invest when times are good and sell when times are bad. Of course the problem with this is that the market has already priced in these potential great or negative times.

This means an investor is playing the greater fool theory of speculation. There are too many variables, which means an investor would need to be quick and accurate in order to make money.

As you may have guessed, there is another issue when it comes to gauging whether certain expectations are already priced into the current stock price.

Imagine you predict the market will continue to grow at 5% and you purchase securities; however the market is expecting 10% growth? You could still lose money because the market was expecting the higher rates of growth.

In this scenario, it’s likely the market already bid up prices in response to the 10% growth. If growth comes in anywhere under 10%, the market could take a turn for the worse, even if it was better than your 5% growth estimate. Identifying the market's expectations should be understood before making any investment.

Value (bottom-up) investors focus on important AND knowable things.

They focus exclusively on the underlying fundamentals of each business that they choose to research. They judge each business on the merit of these underlying fundamentals. This allows for a simpler strategy than that of a top down strategy. Bottom-up investors do not predict, and should never compromise their conservative approach. They normally look at tangible things, and make probabilities based on conservative financial metrics.

Of course this hinges on actually having the ability to conservatively value a security. We discuss this later in The MECOM™ Method and Margin of Safety sections.

When you are able to conservatively value underlying securities, then you must have the patience and discipline to wait until you have a big enough margin of safety from its intrinsic value.

Thus, the actual direction of the economy is of little concern to the bottom-up value investor.

In fact, in analyzing the individual securities, you actually gain insight as to the nature of the overall market. You can see within the underlying businesses that you follow whether the markets are euphoric or depressed (or somewhere in between).

By using a bottom up strategy, investors can point to specific reasons for investment. It becomes much easier to make decisions when you only focus on a few critical variables that matter the most to businesses and investing. There are just too many variables in the macro world to have a great amount of success over the long-term.

It can be very difficult for anyone to change their mind after making an investment. By focusing on these factors and reasons for investment, you can come back to this at a later date. This can help you objectively re-evaluate the investment decision, and if need be, make the decision to sell if you are wrong. This can be difficult to do when there are too many variables in the top-down universe. You may even be biased to latch on to other positive numbers while ignoring your original reason for investment.

By only focusing on a few important and knowable variables, you will make better decisions for the long term as an investor.

There are too many intelligent people trying to predict the unpredictable or unknowable. Investors would be better served not to make investing this difficult.

I, for one, will play on another field using a simple bottom-up investing strategy.

In this section, we learned: how to concentrate on risk before return; how we must have a contrarian streak in order to outperform the market; the importance of having a long-term approach to investing; that few, big and infrequent bets can best lead to outperformance; and how we must remain agnostic of the macro picture to be successful.

In the next chapter we will learn how to Master The MECOM™ METHOD (business analysis).

Let’s get started on the next section!

PART 4: MECOM™ METHOD MASTERY

Do You Have The Proper Analytical Framework?

As you will recall in the last section, we explained the mastery of your morals in investing, and how it provides a base for your investing philosophy.

Since you now have mastery of The Market, Your Mindset and Your Morals we will now dive into detail on your Mastery of The MECOM™ Method.

In this chapter, we will learn how to analyze any business using the MECOM™ Method.

By the end of this section you will be able to:

- Determine whether a business has sustainable competitive advantages.
- Analyze the “real” earnings of a business.
- Pinpoint catalysts that will allow for the stock appreciation.
- Quickly analyze whether a business establishes proper leverage and debt control.
- Determine whether management is competent and trustworthy.

Introduction To The MECOM Method™

"No wise pilot, no matter how great his talent and experience, fails to use his checklist."
Charlie Munger

MECOM™ is *the* framework that helps to systemize informational and analytical data. This is where we will do the bulk of our work.

Essentially this is the checklist for analyzing ANY business (public or private).

The quest to develop this framework began when I started working at an investment firm in 2007, which just so happened to be during the end of a great bull market before the eventual market crash from the Great Recession.

During this time I studied everything I could get my hands on, reviewed every investment I made, researched what other great investors had done and I deconstructed the various variables and components into what you see today.

It didn't take long to realize that I kept coming back to the same variables that seemed to be common among the best investments of the top performing investors, as well as my own.

I will never forget the day I found these commonalities. It felt like I found the **holy grail of investing** by inverting and deconstructing the great investors and their best and most profitable ideas.

I had isolated the most important components and variables that were, in retrospect, obviously the most important to investment success. And I couldn't wait to test it out, and share it with the world!

What you see here today with 5M™ and the MECOM™ Method is the culmination of that comprehensive research and real-world experience managing millions of dollars with plenty of trials, tribulations and triumphs along the way.

MECOM™ serves as a Grande Checklist for understanding potential investment candidates.

It is by no means "THE" grande checklist or all-inclusive thorough analysis of the business. However, if a business does not pass the basic MECOM™ test I will not compromise. It gets tossed in the trash bin.

No checklist is perfect for every situation. The further you go through life investing, the more you realize there is no holy grail. However, hard work and staying within a rational and logical system will serve an investor very well over the long-term. This checklist serves to keep us out of bad or dangerous investments.

Ideally, we want to own businesses that pass all the components of MECOM™. As you will see, there are not many businesses that pass all dimensions of MECOM™, but it's important to know that when you are making too many compromises on a business, it's probably time to walk away from it.

I hate to break this to you...INVESTING IS NOT EASY.

I know this isn't the sentence you anticipated seeing in a book explaining a rise from failure to success in investing, as well as a systematic method for analyzing businesses in 5 simple steps.

Yet, that's just the quandary we find ourselves in --- Investing is simple, but not easy.

This is not a "fast money" type of strategy or process; this process is merely a way to help analyze businesses more effectively and efficiently. A byproduct of this will be compounded returns of your wealth over time.

This checklist is designed to help the individual investor invest better.

This is the entire reason I do this.

I strive to show you a process that you can ingrain in your mind to make investing as simple as possible without wasting any more time than is absolutely necessary.

This process will save YOU hours of analysis and research. The process will fine tune your research and help you focus on the factors that matter most.

Personally, I love reading and analyzing companies, but nothing is more frustrating than spending significant time reading about and researching a company, only to find out that you have to throw it in the trash bin.

MECOM™ helps to weed out the bad apples and not waste time.

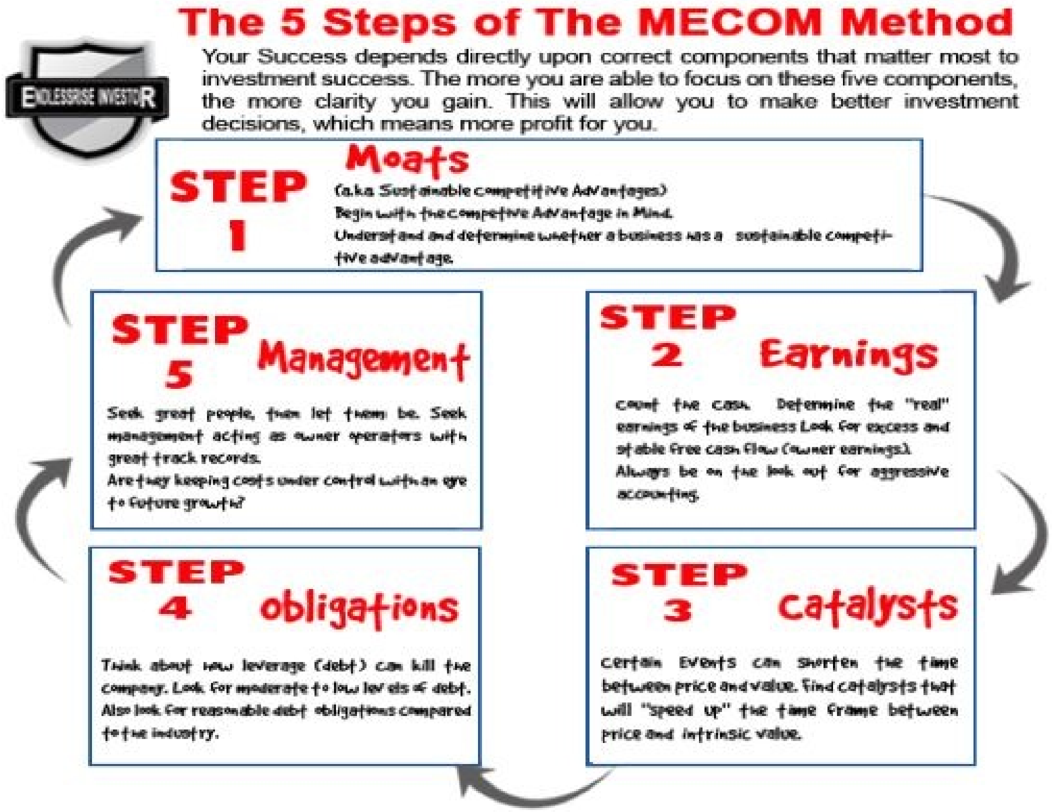


FIG: 8 The 5 Steps of The MECOM™ Method

Looks simple, right? That's because it is. It's supposed to be simple.

I have assembled a simple process through a countless number of hours researching and analyzing businesses and investors. Time and time again I kept coming back to these same variables before making a decision of whether to invest in a business or not.

As I said earlier, MECOM™ is a simple process, BUT investing is not easy. The purpose of this process is not to make investing easy. The purpose of this process is to make it as easy as possible. It will take some work initially, just like anything else in life, but if you stick with it, you will see the rewards of your labor well beyond your wildest imagination.

Click here to access a checklist of the MECOM™ Method

Let's get into the components of MECOM™.

Step 1 of MECOM™: Moat(s)

"The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors."

Warren Buffett

If you have been investing for some time, there's no doubt you've heard of the term moat, as it relates to investing.

For the new investor, you might be wondering what the hell a moat has to do with investing?!?!

Don't worry, I haven't forgotten about you.

A moat was a popular metaphor created by Warren Buffett to describe a business that has a competitive advantage. Essentially the castle is the business and the moat is the competitive advantage.

The moat by itself was not enough though. The castle and its people had to constantly make sure the moat was filled with crocodiles and piranhas, and always filled to the top.

At any moment a marauder could come in and try to attack the castle. The moat made sure it was well defended.

There is a reason this is the first step. Without the moat…well, the business would never survive a sustained attack by the creature that is capitalism.

Capitalism is a brutal and very competitive place. We want to make sure we have some sort of competitive advantage in place before wasting time.

The first question we must ask ourselves is, **does the business have a sustainable competitive advantage?**

Now if you are like me when I first started investing, you're probably asking yourself…

"Great, now how do we determine if a business has a competitive advantage or not?"

Don't get too frustrated --- it's not as difficult as you think.

Of course it will take some research, but I will show you a few quick and dirty ways to invert the process and help speed up the analysis to see if it's worthy of our time (or not).

There are two ways to discover businesses with moats:

1) You go through your vast array of mental models which tell you that a sustainable competitive advantage is a possibility even though the profits have not trickled down to the bottom line yet… (this is difficult for even the most seasoned of investors)

OR

2) You use a simple technique called inversion to find which businesses are able to produce profits above and beyond their competitors right now. Then find out why they are able to do this, and what the probability of them continuing to do this into the future?

When I look for businesses that have moat characteristics, I will use the latter approach, the inversion method.

Trying to understand any business, is a great exercise in trying to solve problems by looking at them both forward and backward.

Charlie Munger explains it beautifully in his speech at the University Of California, Santa Barbara, on October 3, 2004.

Munger loved to give his family puzzles. This was one of them:

"There's an activity in America, with one-on-one contests, and a national championship. The same person won the championship on two occasions about 65 years apart."

"Now," I said, "name the activity?"

"Can you name the activity? How do you come to that answer?"

Munger said only one person in his family answered it correctly because of the way he thought about the problem.

He goes on to say, "I have a physicist son who has been trained more in the type of thinking I like. And he ultimately got the right answer, and here's the way he reasoned:

It can't be anything requiring a lot of hand-eye coordination. Nobody 85 years of age is going to win a national billiard tournament, much less a national tennis tournament. It just can't be.

Then he figured it couldn't be chess, which this physicist plays very well, because it's too hard. The complexity of the system, the stamina required are too great.

But that led into checkers. And he thought, Ah ha! There's a game where vast experience might guide you to be the best even though you're 85 years of age."

Going backwards and forwards in one's thinking can help to improve your ability to solve problems. In the case of Moats, it will help us to delineate whether sustainable competitive advantages exist.

<u>Finding sustainable competitive advantages is best thought of as the exploration process.</u>

This is where you really get to understand the business and its competitors. I love this part the most, however, I am also aware that this is also the toughest part of the entire MECOM™ Method.

Don't despair! I will show you how you can see potential sustainable competitive advantages in a business by looking at it's moat metrics. I will explain the moat metrics in just a little bit.

And before we go any further, I also want to congratulate you for making it this far!

You should be incredibly proud of yourself!

You just made it into the top 2% of investors out there!

A lot of investors (professional and individual) don't even bother with this part of the analysis or they do it incorrectly because they think it takes too much time.

However, this is the most critical part of any long-term investment. Lots of investors think it's enough to focus on only valuation or management. And while these factors are important, you aren't investing in a bubble.

Capitalism is a dynamic environment and we must be able to determine whether a business has a competitive advantage, so it can compound our investment over the long-term. High-return businesses will constantly be assaulted by competitors. It's the nature of capitalism.

As I stated before, there is no need to worry.

I will show you some quick tips using the moat metrics to discern whether a business has a potential competitive advantage(s) or not. We can then compare them to other competitors to qualify whether a true competitive advantage exists or not.

Let's start by identifying the different types of moats.

Essentially there are five main types of competitive advantages:

1. Intangible assets

2. Tangible assets
3. Cost advantage
4. Customer switching costs
5. Network economics.

Pat Dorsey (Dorsey Asset Management) has done a tremendous amount of work on competitive advantages so he deserves the hat tip on this one.

1)Intangible Assets

The thing that can be complicated about intangible assets is that they're intangible.

It can be difficult to classify exactly what this competitive advantage means. There is a great deal of work that must go into whether a business possesses intangible competitive advantage(s).

Generally, an intangible asset pertains to the things that make a company unique. Things that are untouchable by other companies such as brands, licenses, trade-marks, patents, and other intellectual property. It may also include geographical advantages and company culture, which can affect the durability of a competitive advantage.

A great example of brand loyalty and intangible assets at work can be seen through brands like Harley-Davidson and Apple.

More than one hundred years ago Harley-Davidson set up shop, and although there are many other brands and styles of motorcycles around the world, this one stands above the rest. In fact, these bikes are so popular that many men and women have the brand name tattooed on their skin.

Would you classify that as a rabid and loyal fan? I would!

Apple, on the other hand, is hailed as one of the leaders in portable media, music and communication. As a result of their fans' brand loyalty, their products rest at the top of the price charts, while their competitors (who offer similar products at a fraction of the price) don't get nearly as much business. This brand power is one competitive advantage that Apple holds above the rest.

Because this competitive advantage is intangible in nature it is also subject to change very quickly.

2) Tangible Assets

Lots of investors wouldn't include tangible assets as a competitive advantage. However, I will disagree with this one.

A business that owns real estate or land that is strategically located at vital corners around the world offers competitive advantages that others could never touch.

Imagine owning that one hotel right on the beach in Miami or owning a building in the middle of Time Square. These are big-time competitive advantages if managed correctly.

For example, think about airports.

What is more strategic and vital to an area than an airport?

Ferrovial SA (FRRVY) is based in Madrid and owns two of the best infrastructure assets in the world: London's Heathrow Airport and ETR-407 toll road in Toronto. The long-term agreements and pricing power provides them with a great margin of safety (as long as management doesn't squander it).

What about sporting venues?

Madison Square Garden (MSG) is probably one of the top five (if not top) sporting venues in the world. This strategic location and iconic status should provide them with a steady recurring revenue stream and adequate pricing power in the "city that never sleeps."

How about billboard advertising and real estate?

Lamar Advertising (LAMR) owns real estate via billboards in small to mid-tier markets. The real estate is strategically located, and the company has a strong market share. In addition, many of the areas they own advertising real estate, do not allow new billboards.

As you can see, tangible assets can hold a spot on the mantle of sustainable competitive advantages.

3)Customer Switching Costs

Customer switching costs is a powerful advantage in the business world, as they open up the ability for companies to raise prices and change policies without losing customers.

These switching costs are usually a one-time cost that makes switching from one company or service to another too expensive or inconvenient to bother. Having high switching costs can keep consumers from taking their business to a competitor, even if the competitor has better prices or products.

One place where this type of competitive advantage is seen frequently is among mobile phone companies, who lock their customers in for a period of one to three years through a discounted or free mobile device.

This contract forces customers to stay within the guidelines and policies of their contract or be forced to pay a penalty in order to be released early. These costs can vary depending on how long is left on the contract, and while some companies charge fairly reasonable rates (although they're higher than average), others make it nearly impossible to make the switch.

Sometimes these costs aren't financial at all, but rather the costs are measured in learning curves, because switching from one product to another means learning to identify an entirely new user interface and operating system.

Switching from a Mac to a PC is a good example of this learning curve.

Adobe would fall into this category too.

4)Network Effects

The way that a network effect occurs in the world of moat economics and competitive advantages is very interesting.

As a business or product increases in value and popularity for new and continuing users, sudden increases in growth across a network of consumers, can actually raise the company to the top of their industry in relatively short order.

This is recognized as one of the most important competitive advantages because it can make such a vast difference in a short period of time.

A great example of this is credit cards.

I am willing to bet that everyone has a credit card in their wallet right now. A VISA, MasterCard or American Express? So why do you have them in your wallet?

Yes, obviously to make purchases on credit or debit.

But why do you carry those specific brands?

It’s because merchants accept them, and as long as you carry them, merchants will accept them. It’s a vicious network effect cycle.

Ebay is another example as more and more people come to one location to sell their goods.

Social media networks are another example of how quickly businesses can grow when you have tremendous network effects.

5)Cost Advantages

This is probably the most important sustainable competitive advantage --- especially when it is combined with other types of moats.

All consumers are looking for a deal on products that they buy, which means that companies that can get their products to customers at a lower price than the competition have a competitive advantage over similar businesses.

Being able to undercut a rival company on the cost of goods or services is a bonus. Additionally, companies who can produce at a lower cost can also charge at the same price point as competitors but make more for their efforts. Cost advantages can be a difficult competitive edge to gain in the early stages of business because they often require very large orders to achieve the right balance for lowered prices on goods.

As a company builds and expands into a larger entity with the buying power, it will be capable of purchasing larger orders to lower costs and gain more profits.

A prime example in this category is Wal-Mart.

This retail giant operates all over the globe, providing consumers with essential products from all ranges of life at competitive prices.

Having thousands of stores globally makes Wal-Mart a very strong competitor in its market, and because of its size it not only sells its products for less but is able to keep costs low for customers and still make a large profit.

Delivering lower prices than a competitor has been explained as cost advantage, but there are other cost advantages that consumers think about as well, such as convenience, speed, and exceptional service.

Providing better all-around products than other companies can produce an enduring competitive advantage for a business. It is difficult to pinpoint and calculate, but it is surely possible.

Having superior value based on craftsmanship, service, functionality and design can also give a business an advantage over its competition and make a claim in the market for a company's brand and ability.

Starbucks and Whole Foods are great examples of this.

That’s Great --- But How Do We Find ‘Em…?

So, now we know what to look for as sustainable competitive advantages.

Now it’s time to look at the *“Moat Metrics.”*

I use certain metrics and numbers to find moat type businesses. I started to call them “Moat Metrics” and it just stuck, so I continue to say it to this day.

These metrics are numbers or ratios that show a high quality, high return business.

Establishing whether or not a business actually has a competitive advantage can leave much to the imagination. In this particular instance, I believe it’s best to use a process of inversion to help us locate businesses with the potential for sustainable competitive advantages.

We do this mainly through screening for businesses producing excess amounts of free cash flow (FCF) and excess return on invested capital (ROIC).

All the cash in the world doesn’t mean anything for the future if you aren’t able to consistently reinvest the cash and produce outsized returns.

Essentially, <u>Cash Flow Is Great, but Reinvestment Opportunities Are The Driving Force Behind Outsized Compounded Returns Over The Long-Term.</u>

ROIC helps us determine whether there is potential for reinvestment. If I had to pick one metric to focus on to help pinpoint businesses with sustainable competitive advantages, it would be ROIC.

Thus, we will focus intently on this metric.

ROIC businesses are commonly referred to as compounders because they are able to reinvest their cash flow. The more cash that is produced by the business, the more room for reinvesting which provides for growth and compounding. You can see the appeal of investing in these types of businesses.

The trick is threefold:

1) Finding these businesses
2) Objectively determining whether they will produce these returns in the future with a high probability
3) Buying at a margin of safety

If you can locate these consistent ROIC businesses, it will lead to the power of compounding over time.

Jae Jun at OldSchoolValue.com has an easy to navigate stock screening suite for free. Feel free to check it out here:

http://www.oldschoolvalue.com/stock-screener.php

Will They Continue To Produce These Returns?

Once we find these businesses, how do we know if they will continue to produce these returns?

Unfortunately, past performance doesn't necessarily pay itself forward. You don't profit from the growth of yesterday.

So how do we determine whether a business will be able to produce consistent levels of ROIC into the future?

There is no easy answer. The first thing you want to do is time travel.

Wait…What!?!?

Yes, time travel.

You need to take a step back, try to see the forest through the trees, and objectively analyze whether the business will likely be doing the same thing in 5-10-15 years that it's doing now.

Take *Apple (AAPL)* for instance: It's a great company and produces a ton of excess free cash flow with high ROIC. It has established a great ecosystem and network effects with iTunes, and their customers are incredibly loyal.

But…

Are we able to predict, with a high level of probability, how the next generation of iPhones, iPads, and MacBook's will be perceived by consumers? And will they buy the new apple products? Will competitors poach the talent from Apple (Tesla's already taking Apple employees)? Will new competitors create better devices which will drive customers away from the Apple ecosystem?

This constant change in technology and innovation puts many technology businesses at a major disadvantage (not un-investable, but at a disadvantage nonetheless) because of its ever evolving and changing land-scape.

This is not a knock on Apple. I think it's an incredible company with lots of cash and relatively no debt, and it has established a great network of loyal fans. I just can't really see where the product line will be in 10 years with the increased competition and low barriers to entry (as well as continued leadership of the company).

We want businesses that have stable industry characteristics and high barriers to entry, such as railroads, beverage producers, and banks.

Conversely, I can predict with a higher degree of probability that *U.S. Bancorp (USB)* will sell low-risk mortgages and produce return on equity (ROE) in the mid teens.

I can also predict with an even higher degree of probability than Apple, that *Union Pacific Railroad (UNP)* will likely move more goods and services in the U.S. while earning at least 20% ROE in 10 years.

In determining whether a business will be able to continue producing ROIC, an investor would need to objectively understand whether the business will likely be doing the same thing, with relatively the same impact/results, that it is today. This involves having an understanding of the actual business, its management, the industry and their competitors.

If you believe a business will be able to consistently produce FCF and ROIC into the future, then determine a conservative estimate of intrinsic value using FCF, compare the intrinsic value to current market prices, and decide whether your margin of safety is sufficient.

Are you invested in businesses with sustainable competitive advantages?

Sustainable Competitive Advantages Don't End With The Business

I believe it's just as important for individuals to have competitive advantages in life, as well.

It could be your smile or your good looks or your patience or your ability to take action or maybe even your superior intellect.

It could be any number of things…

The point is to find a competitive advantage that gives you a leg up on your competition. Once that competitive advantage is known, focus on growing that advantage (as well as finding new ones). Never stop learning and providing value to others.

For example, I believe value investors, in general, have a myriad of different competitive advantages which sets them apart from the rest of the investing arena, such as:

- Avoiding the noise of the overall market and macro forecasts
- Investing for the long-term with very low turnover
- Valuing businesses, not stocks
- Using a Price/Value Strategy for stock selection
- Going beyond GAAP (Generally Accepted Accounting Principles) in ascertaining the “real” value of the business
- Executing a very focused portfolio of no more than 20 holdings

It is important to remember, not all competitive advantages are created equal.

A company’s management team should look at its own competitive advantages critically to determine which ones are most beneficial to the business. Then they should do anything in their power to protect it.

If you ever ask an executive what their competitive advantage is and they don’t have an answer…

Run the other way.

Big businesses, and small businesses alike, will require different game plans as far as potential competitive advantages, like cost advantages and network effects.

For instance, a retail company will focus on its competitive advantage differently from medical companies or the entertainment industry.

In order for a business to correctly execute its plan for sustaining its competitive advantages, a business must remember that this may go against what analysts on Wall Street think they should do.

It is important for a business and its management to be focused specifically on the type of industry that they work within and how their business relates to its consumers and the environment in which it's been established.

Listening to financial “experts” and succumbing to Wall Street’s every whim, is a sure recipe for disaster over the long-run.

Whether you choose to focus on the five types of competitive advantages, or you're already implementing a few of them in your life or your investments, it's important to monitor their success rates. You should also keep an eye on the level of your particular moat, and whether it is helping the business grow (or not).

It can be easy to spend too much money on a great idea or something you think the customer will love. However, losing track of a business's real competitive advantage and protecting that competitive advantage can mean all the difference between success and failure.

Does your business have a competitive advantage over its competition?

What are some of your competitive advantages that you would like to share?

Step 2 of MECOM™: Earnings -- Can you count the cash?

"The critical investment factor is determining the intrinsic value of a business and paying a fair or bargain price."
Warren Buffett

When analyzing a business's earnings you always want to ask yourself if you can count the cash.

Does the company produce excess FCF?

It seems every major collapse of stocks reminds us what we need to focus on the most.

The one determinant of a great business or worthwhile investment is the cash that you will be able to take out of it eventually.

The illusion of earnings by solely focusing on "earnings-per-share" (EPS) is an often used barometer in determining the valuation and quality of a business.

Time and time again the new crop of analysts, Wall Street investors and executives fixate on these readily-attainable numbers despite the horror stories of the past when people focus solely on these generic and easily-manipulated numbers.

And it's such a travesty.

But it does serve an important lesson: Never get "seduced" into great investment stories because of rapidly growing stock prices, revenues or EPS.

It's far better to focus on another measure of earnings to determine quality and corporate performance, such as free cash flow or ROIC.

It is much more difficult to manipulate the cash flow statement. Income statements are notorious breeding grounds for subjective reporting and accounting shenanigans to help the company hit Wall Street's often aggressive projections and targets. As a result, we don't want to focus too much on the income statement as far as earnings are concerned.

Remember: Cash is king! It needs to flow though to FCF or owner earnings for it to mean anything.

The more free cash flow a business will be able to generate over time while reducing debt, the higher the intrinsic value will be over time.

By focusing solely on free cash flow (and owner earnings), we can focus on the actual dollar amount that can be returned to shareholders through four main activities:

1) Reinvestment
2) Debt reduction
3) Dividends
4) Buybacks

These continued activities WILL raise the price and intrinsic value over the long-term.

Free Cash Flow Isn't Just a Barometer for a Quality Business.

Discounting these free cash flows back to its net present value can help you calculate an intrinsic value of the business as well (based on conservative estimates, of course).

Don't be scared by this…

We will go over this simple valuation calculation in the margin of safety section coming up next.

In researching and finding the correct earnings of the business, we want to focus on Free Cash Flow (or owner earnings), first and foremost.

If the business does produce excess FCF you can move on to the next component of the checklist.

If the company doesn't produce FCF (or owner earnings) or has no hopes to ever produce it, then it's a pass.

This is when I always need to remind myself of the KISS principle --- Keep It Simple Stupid.

No need to make investing any more difficult and complicated than it needs to be.

Keep it simple!

Where To Find:

Cash Flow Statement (gurufocus.com, morningstar.com)
Free Cash Flow (FCF) = Cash From Operations – Capex
Owner Earnings = NI + D&A +/- Other Non-Cash – Annual Maintenance Capex +/-changes in working capital

Stable FCF And Revenue Growth Over Last 10 Year Period?

Not only must the business be able to produce free cash flow, but you want to make sure you have a high probability the business is able to produce these results over time.

Oddly enough, the only way to do this is by looking backward.

Stable and growing FCF and revenue over the last 5-10 year period can help us conservatively estimate with a higher degree of probability the intrinsic value of the company.

While there is no guarantee of what the future holds, the past stability or growth of the business shows the quality and potential staying power of the business. At the very least, the stability of the business provides us a sound base from which to calculate conservative mathematical calculations.

We look for four main types of businesses for recurring revenues/cash flow business models:

1) Service businesses (high quality w/ high switching costs)
2) Franchisors
3) Subscription based businesses
4) Razor/razor-blade type businesses

Of course the business of today doesn't profit from yesterday's stability or growth.

So, it's important to also have an eye to the future as well.

Is there a competing technology, service or product that is better quality and/or lower cost?

These are the types of questions you want to ask yourself when you are investing for the long-term.

The graph below of Coca-Cola (KO) shows a perfect example of a stable business that has been able to grow revenue, free cash flow and equity for an extended period of time.

FIG: 9 Coke (KO) Revenue / Free Cash Flow / Total Equity

As a result, the share price increased as well.

FIG: 10 Coke (KO) Share Price

Essentially, the stability of earnings gives us an element of predictability.

This element of predictability gives us a better opportunity to calculate the correct intrinsic value of the business.

This is the reason we require the stability of earnings and revenue.

Where To Find:
Income Statement (gurufocus.com, morningstar.com)
Cash Flow Statement (gurufocus.com, morningstar.com)

Gross / Net Margins Are Best (near best) In The Industry?

This may be Warren Buffett's greatest secret.

Focusing on the margins of the business (gross and net) can tell you a great deal about the quality of the business and the industry as a whole.

In fact, gross and net margins are part of the previous "moat metrics" section in searching for businesses with sustainable competitive advantages.

The profit margin is what's left over to the business after the costs of running the business. Simply stated, it's the profits divided by sales that will give you a profit margin percentage (the higher the better).

So why is profit margin so important?

The profit margin essentially paints a portrait of the competitive landscape in that industry, as well as how the business is competing in that industry.

Low-Margin Industry: grocery stores and discount retailers are notorious for incredibly low profit margins. The industry as a whole has very few barriers to entry, and it's very difficult to build sustainable competitive advantages.

High-Margin Industry: railroads and beverage distributors have been high profit, high return businesses for decades. The industry has strong barriers to entry with high capital expenditures and distribution factors giving them sustainable competitive advantages.

Our obvious choice between a high margin business or a low margin business is easy.

We will focus our attention and energy to high margin, high return businesses.

Where to Find:
Income Statement (gurufocus.com, morningstar.com)

Is The Business Conservative In Its Accounting Of Earnings?

In ascertaining whether a business is conservative or aggressive in its accounting of earnings, we must first understand whether GAAP (generally accepted accounting principles) are representative of the “true” earnings of the business.

There is no easy way to go about this step, but I will provide a little trick at the end of this chapter.

We need to determine if management uses aggressive or conservative accounting standards. Trust me when I say there are a number of ways management can manipulate earnings:

- **Over or Under-Stated Expenses**

  Short-term earnings can be temporarily boosted if management decides to move current expenses to later periods.

- **Inflate Sales**

  By booking a sale before it is actually earned, revenue can be artificially inflated. An example would be management coercing distributors or re-sellers to take more product than they need.

- **Change Accounting Methods**

  A business that changes its accounting methods or firm is a red flag that must be looked into very carefully. You will find this information in the footnotes, but make sure the change is for a legitimate reason.

- **Use of Reserves**

  Reserves are used for a number of reasons: potential litigation, warranties, liability, product returns or bad debts. This can be a very subjective line item, so just be aware by comparing the actual accounts to the doubtful accounts. Watch out for any large changes.

- **Restructuring Charges (one-time expenses)**

  Management could add extra expenses to a restructuring charge, thereby decreased expenses in the future to make it look like the business is earning more than it really is. This is a favorite tactic of new CEO’s. Sometimes it’s justified, but many times it’s not.

- **Discretionary Costs Manipulation**

  These include R&D, marketing and advertising expenses, as well as basic maintenance costs. By dramatically cutting back in any of these areas, it can manipulate the earnings to look higher than they really are.

*Many of these subtle manipulation hints can be found in the footnotes, which makes them very important to pay attention to on a regular basis.

We won't go into detail on all the different ways that management can manipulate earnings (especially with the income statement). That's a topic for a whole book. In fact, I will probably write one someday.

The point is, management has a great deal of "wiggle" room when it comes to reporting the actual earnings of the business. The manipulation can be quite extensive.

If you are interested in knowing more about earnings manipulation and how to spot it correctly, there are two books I highly recommend:

- Quality of Earnings by Thornton L. O'glove
- Financial Shenanigans by Howard Schilit and Jeremy Perler

Just recognize that the picture management paints, isn't necessarily reflective of reality.

Here are a couple of tricks I discussed earlier to help you quickly spot potential manipulators. Obviously, this is not a panacea for finding earnings manipulators, however it is a great place to start and save some time.

Trick #1: Net Income and Operating Cash Flows Tracking Together

As you may have noticed, I am not a very big fan of the income statement. The cash flow statement allows for much less flexibility (and potential manipulation) than the income statement. Which is why we use the cash flow statement to "check-in" on the income statement to make sure everything is reasonable.

If operating cash flow deviates too much from net income, you can be willing to bet that management is utilizing aggressive accounting standards --- Especially if it has deviated for an extended period of time.

See an example of how we analyze this using the chart of Coca-Cola (KO) below.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Net Income	$ 4,847.00	$4,872.00	$5,080.00	$5,981.00	$5,874.00	$6,906.00	$11,837.00	$8,646.00	$ 9,086.00	$ 8,626.00
Operating Cash Flow	$ 5,968.00	$6,423.00	$5,957.00	$7,150.00	$7,571.00	$8,186.00	$ 9,532.00	$9,474.00	$10,645.00	$10,542.00
	81%	76%	85%	84%	78%	84%	124%	91%	85%	82%

FIG: 11 Coke (KO) Net Income to Operating Cash Flow (OCF)

As you can see from the chart above, we analyzed Coca-Cola Net Income vs. Operating Cash Flows for the last 10 years. There is a close enough approximation of the two and it's steady, so there are no apparent red flags, although operating cash flows have historically tracked higher.

If net income levels were consistently higher (>25%) than operating cash flows, it would raise a huge red flag for virtually any business.

At this point you would need to dig into the company deeper, but I would be willing to bet there was some sort of earnings manipulation going on under the surface.

Trick #2: Read the income-tax footnote in the 10-K.

Another trick in learning whether the business engages in aggressive or conservative accounting methods is to check the difference between the tax paid to the IRS (current taxes) and GAAP taxes (income tax provisions).

In the 10-K (Annual Report), there will be an income tax footnote that you must analyze. Once you have located the income tax footnote, you want to compare the differences between Current Taxes and Income Tax Provision for at least the past 5 years.

The point of the comparison is to evaluate how understated or overstated the earnings are for that period of time. There should be red flags going off everywhere if you realize the business has been profitable and not paying taxes.

On the other side of the equation, if current taxes and provisioned taxes are in-line, this essentially means that "real" earnings are similar to GAAP earnings. This tells us that we wouldn't need to make any major adjustments to our earnings calculation. More than likely the business is conservative in its accounting methods.

BOTTOM LINE: There are a myriad of different ways for management to window-dress earnings results. If a business's accounting is too difficult to understand, then management usually has it this way for a reason.

Stay clear of businesses that aren't completely transparent with regard to their accounting policies.

These two tricks should help you quickly and efficiently decide whether a business is high quality or trying to take you to the cleaners.

Where To Find:

Income Statement (gurufocus.com, morningstar.com)
Cash Flow Statement (gurufocus.com, morningstar.com

Footnotes of 10-K of the business (Investor Relations Webpage, SEC)

Step 3 of MECOM™: Catalysts

"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."

Seth Klarman

Catalysts help us pinpoint potential events which will cause the business to grow and/or the stock to rise.

Cheap prices can sometimes be enough of a catalyst for share price appreciation, however we want a greater assurance for share price appreciation and margin of safety.

The presence of readily established catalysts helps to increase our margin of safety by potentially increasing the speed of return.

We define catalysts in 5 main categories in order of importance:

1. Future growth in the underlying business
2. Future growth in the industry
3. Management catalysts
4. Business catalysts
5. Supply/Demand catalysts

Shareholders benefit in two ways after a stock is purchased at a discount from a business's underlying value:

1. The stock begins rising to converge with its underlying intrinsic value.
2. An event(s) occurs which causes the value to be realized instantly or over time by other market participants.

Although an investor will likely do extremely well over the long-term by purchasing businesses at deep discounts to their intrinsic values, we want further confirmation. We never want to be completely held captive by the vagaries of human nature and the irrational behavior of the markets.

We want to invest in high quality businesses at deep discounts to intrinsic value, which have likely events in the horizon to bring about full value of that investment.

Investors call these events “catalysts.”

Catalysts reduce risk and help investors by:

- Reducing their dependence on market forces for investment returns
- Fast-tracking the time between price and value

All of this helps to increase an investor’s margin of safety over time.

Is There Future Growth In The Underlying Business?

We all know businesses create a lot of value for an investor, if they are able to grow profitably over time.

The *main reason* we want this growth is so we can participate in the benefits of compounding in a tax-deferred manner.

Holding onto a reasonably priced business that continues to grow year-in and year-out allows you to reap the reward of a rising stock price without ever having to sell. This is why we focus so intently on sustainable competitive advantages. The ability of a company to continue to produce excess profitability over the next 10-20 years, and beyond, increases the business’s intrinsic value that much more.

Many of the best investors of our time figured out this strategy early on in their careers. Still, others try to make it more difficult than it needs to be. It doesn’t take more than 3 or 4 great investments to make an incredible difference to your investment returns. In fact, I am willing to make a wager that the bulk of your investment gains in your entire life will come from less than 5 businesses.

Just think, all you would need to do is sit back and let the compounding effects of your top 5 ideas take you to levels you never before imagined. You simply find high quality, moat businesses and buy them at reasonable prices. That’s it.

The only problem is….an investor doesn’t know which investments will get them there. You can have a general idea, but you never really know until it happens. This is why we still want to purchase the growth in these businesses with a margin of safety.

Investing strictly for growth can carry many risks. Now, don’t get me wrong, you certainly want the growth in the business -- you just don’t want to pay too handsomely for it. When you purchase these “high quality, moat” businesses, you will normally be paying a higher price than you are used to for that growth.

You must never be afraid of paying a reasonable price for a high quality business. Time is the friend of high quality businesses.

“Paying-up” is acceptable, but it comes with a caveat: You must be able to determine if a business is likely to continue growing.

There are four main questions we use to help us better understand the future growth of the business. You can view them below to help you in being able to determine whether a business is likely to continue (or embark on) its growth trajectory:

- What are the growth prospects for the future of the business?
- Is the business growing at an undisciplined or unsustainable rate?
- Will the historic profitability continue to grow?
- What is management’s incentive to keep the business growing?

1)What are the growth prospects for the future of the business?

You can actually find this information in the Management, Discussion and Analysis (MD&A) section in the 10-K (annual report). Management will discuss opportunities for growth, so you want to pay particular attention to this section. It is important for you to stay very objective in your analysis of this section. Management is usually incredibly optimistic, so you always want to make sure that the growth opportunities and projections seem reasonable.

Here are a few tips on where to focus your attention:

Have R&D labors been effective? Or are they likely to be effective?

Innovation and R&D can help a business to stay on a growth trajectory by constantly producing better products and services than the competition. But this doesn’t just happen out of thin air. Testing, research and development are essential parts of a great business that wants to continue to get better. Keeping a constant eye on R&D expenses as a percentage of sales can give you a good idea of the culture.

For example, Google (GOOG) spends over $2.5 billion per quarter on R&D expenses which means they consistently spend over 10% of their revenues on R&D to improve their products, user experience, and develop new products. This kind of R&D spend as a portion of revenue makes it very difficult for other players to compete.

It enables the business to continually improve the user experience in search, as well as develop new products or entirely new business segments (think their self-driving cars).

A business that is able to continually increase the quality and value of its products and/or services will produce competitive advantages for that business over time. In fact, Google controls more than 65% of its main business segment, making them the largest global search engine player in the world by a staggering margin.

Of course, this doesn't mean that the business isn’t immune to unsuccessful R&D campaigns. A good way to evaluate successful R&D expenses is to compare the percentage of sales from new products or innovations.

For example, Apple (AAPL) is all the rage right now (and who could blame them). Their R&D has contributed greatly to new generation iPhone and iPad sales. The iPhone 6 debuted in October of 2014, and blew the “doors off the hinges.”

They posted earnings of $8.5 billion on revenue of $42.1 billion, thanks to the iPhone 6 sales. This was an 11% and 6.3% increase, respectively, from the same quarter the previous year.

Apple has spent an average of 4% of its sales dollars on R&D programs since 2005. This yearly R&D expense has helped Apple to drive revenue growth per share of 35.7% per year over this period. That’s very impressive.

As you can see, R&D can have a significant impact on the future growth of the business, when executed properly.

It is important to note that there can be a noticeable lag in ROI from R&D, as well. So, that must be taken into account.

Are transformative products / services needed for the business to grow?

The constant design and production of new products or services can be extremely demanding and difficult to execute over time.

The problem lies in not truly having a historical base to help fathom whether the new product or service will be successful. Even with a perfectly executed testing strategy and early sales data, it's essentially a guessing game (and not a highly probable one at that).

Remember: most new product launches fail. For every new successful iPhone or iPad launch, there are 10 or more that failed miserably.

Innovative companies like Facebook, Tesla, Apple and Google are difficult to forecast because their products and services are transformative. In some instances they are even creating new industries from their innovative and entrepreneurship minded culture.

Personally, I think it’s great. I think it’s great for our future and great for society. And I admire those businesses and their leaders. We certainly try to invest in them at the right prices.

However, as an investor, it makes it very difficult to forecast anything that's never happened before. Sometimes it takes a bit of imagination and creativity with a hint of rational pragmatism.

So how do you figure out whether there is potential growth with these businesses when there is a very low probability of predicting the future?

Consumer Reports (paid)

Consumer Reports is an excellent publication to help you find unbiased ratings, comparison and user reviews on products (new and old).

Talk to/Interview current or target customers

Your friends can be a huge help here. Call up some of your better friends that use this product and ask for their opinion of the product. Even if they don't have the product, ask for their opinion of it. Product message boards are a great resource as well.

Don't be afraid to venture out to any of your social media sites and ask your friends. It is amazing the kind of answers you will get. You'll start thinking of things you never contemplated before. Social media networks earn their "chops" for this access to valuable feedback alone.

Interview/talk to employees or executives of the business

Talking to the actual employees and executives of the business can help you tremendously if ascertaining the believability and culture of the business.

It's kind of funny, but salespeople are probably the best employees to interview because they are in the trenches. If they are having difficulty selling a product or service, that's a warning sign.

Interview/talk to employees or executives of the competition

I always try to ask company executives who/what scares them most in their competitors. If they say nothing, there's something wrong. If they answer truthfully, you will have a great understanding of the truly innovative companies in the industry, as well as the best products/services.

You can find information on employees and executives of these businesses on social media (specifically LinkedIn) or the company website. It has been my experience that they are more responsive on social media.

If you find answers that are consistent and reasonable, you know that the business has a higher probability of executing on new product launches. This increases the likelihood of increased sales in the future, as well as it being a potentially good investment opportunity.

A byproduct of this research is it gives you a greater understanding of, not only the business and its competitors, but also, the “true” culture of the business.

It’s a Win-Win!

Are there warning signals showing slow growth ahead?

There can be many warning signs to a business's growth slowing down. Here is a list of potential warning signs that you should be aware of before investment:

The company makes a change in business model

It doesn’t take a genius to realize, if a business is changing its business model, there’s likely to be some troubles ahead. That’s not a good thing. Even if the business must change its business model because the industry is too competitive or no longer profitable, it will be difficult for a business to properly execute a change in business model without a certain level of expertise.

There are numerous examples of failed changes in business models, but this doesn’t mean it can’t be done.

For example, PayPal was originally envisioned to be a cryptography company. That’s code for web security company. You see what I did there. I keep telling my wife how funny I am, but she doesn’t believe me.

After several years of difficult times, PayPal finally found its business model with online payments. It wasn’t easy, and the executive team contemplated giving up, but their flexibility and competitive spirit prevailed (again something to be said about entrepreneurial culture of a business).

PayPal was able to execute this change in business model and reach heights never imagined. Although this example shows it can be done, you should view changes in a company’s business model with a keen eye.

If you view PayPal as the exception, rather than the rule it will help you pinpoint a potential slowdown in growth.

The company starts targeting new customer bases

If a business’s core group of customers is starting to slow, management will start to seek growth elsewhere. This is a sure indication of slowing growth ahead, and one we want to be aware of in the language of the Annual Reports.

The company begins to increase its dividend payout ratio

This is a sneaky and subtle signal of limited or slowing growth. When a business is unable to use cash flow for re-investment in the business or find reasonable acquisitions, they will start to return more of the cash to shareholders in the form of dividends (first time or increase in dividend payout).

The *dividend payout ratio* is defined as the percentage of earnings paid to the shareholders in dividend payments.

Let's say a business consistently has a payout percentage of 20% every year. If this number starts to increase (all else being equal), you can rest assured that this is a subtle hint that management is having difficulty finding opportunity for growth.

It's also interesting to pay attention to *businesses that initiate dividends for the first time* after a tremendous period of growth.

For example, Apple (AAPL) initiated its first dividend payout in August of 2012 after years of impressive growth. This was a worrisome sign for investors that paid too high a price for that continued growth. Subsequently, Apple did start to slow and the stock price eventually came back down to earth after a 40% drop from its highs --- effectively washing out the weak holders of the stock.

FIG 12: Apple Issuing Dividends For The Fist Time

Of course once the dust settled, this was still a very high quality, GROWING business. It just wasn't growing at the rapid rate it once was in the past. This, coupled with changes in future leadership at Apple, created a sense of uncertainty in the stock even as the business continued to grow.

This is yet another example of opportunity presenting itself in the stock market.

By not buying popular stocks bid up to unreasonable prices because of growth and momentum, an investor is better able to take advantage of opportunities when they present themselves. The investor that was able to qualify Apple as a high quality business, while sitting back patiently and disciplined, was able to purchase Apple at incredibly risk averse levels after the panic was over.

The best businesses will be able to balance reinvestment opportunities with a stable dividend payout ratio. If they are truly great businesses, they should be able to do both.

Did the business make a management change?

Management changes during growth phases are an interesting topic. I could probably write a whole book on this topic alone.

Essentially, you want to make sure the team that was responsible for the growth of the business is still in place at the helm of the business. If they are removed for some reason, you must make sure the new management team is a protégé of previous team or has been successful at previous companies.

Very rarely do great executives appear out of thin air without ever being successful before. A history of success is the best predictor of future success.

When ascertaining whether a business is likely to continue on its growth trajectory, it is incredibly important to never overlook management's role in the growth.

A management team that has been part of the historical growth, should give you a higher confidence of continued growth versus a new management team that has never proven itself.

It has been my experience that management teams don't get enough credit for growth of the business. Most businesses come to regret letting go of these teams and usually find out after significant turnover in management.

"I try to buy stock in businesses that are so wonderful that an idiot can run them. Because sooner or later, one will."

Warren Buffett

I’m all for finding great businesses that anyone can run, but I also keep close record of great management teams. Just as great investment opportunities don't come along very often, neither do great CEOs or management teams. When you find a great manager try to never let him/her go. At the very least keep track of the manager and his/her protégés.

And of course, when you find those great businesses with great management teams, you have hit the investing jackpot.

Steve Jobs is probably the most famous example of this scenario. Steve created Apple from the garage in his house. And after incredible growth, he was ousted from his own company when the board of directors sought a different path for the business.

After being ousted from his own company, he went on to launch NeXT Computer in 1985 which was bought by Apple in 1996. Once again he was rejoined with his old company which was but a pittance of its former self. Jobs went on a mission to turn Apple around and the end result is technology that is part of our everyday fabric.

He was responsible for iTunes, the iPod, the iPhone, the iPad, iTunes store, touch screens and many of the awesome apps we use every day.

Steve Jobs was a very special and dedicated owner operator, however there have been many others, such as Larry Page at Google, Michael Dell at Dell, Howard Shultz at Starbucks, Reid Hoffman of LinkedIn and Charles Schwab of Charles Schwab.

Great managers matter in commodity-type businesses. This is an important concept to be aware of when investing in a business with new and unproven management teams.

Does the business possess interesting future growth prospects?

The main question we want to answer here is:

Can the business model be repeated or replicated (the more global the better)?

If the answer is yes, then the next question we must be able to answer is *how long can it be sustained?*

This is the most important question, and one that should not be taken lightly. After all, a business that has the ability to grow forever is better than a business that will become obsolete through technology or other means.

For example, let’s look at the 2014 MD&A section of the 10-K for DirecTV, which provides digital television entertainment in the United States and Latin

America.

In the 2013 MD&A section of the 10-K, Management discloses that the subscriber base has grown from 28.1 Million subscribers as of the end of 2010 to 37.8 Million subscribers at the end of 2013 (10% CAGR). This gives us a great picture of a rapidly growing business that could present a possible investment opportunity now, or in the future. Either way we may have a great business with a recurring revenue stream on our hands, and at the very least we should put it on our watch-list if it meets the rest of our criteria for a great business.

We want to always have an understanding on the source of the earnings growth too. In order to do this we want to compare earnings to relevant metrics of the business. In DirecTV's case it will be the subscribers.

DirectTV	2010	2011	2012	2014
Subscribers (millions)	28.1	31.8	35.6	37.8
EPS (diluted)	$ 2.30	$ 3.47	$ 4.58	$ 5.17

FIG: 13 DirecTV Subscriber Growth with EPS

In this case, we are comparing subscribers to earnings-per-share (EPS). You can see from the figure above that as subscribers increase, so does EPS (fig. 13). If instead, EPS increased while subscribers decreased, then it would indicate the business was getting creative underneath the surface by cutting costs or some sort of variation. Of course, these types of tactics are less sustainable foundations of earnings growth.

This table would imply that subscribers are the main source of earnings growth.

Through our quick analysis, we see that DirecTV is growing at a very healthy rate through it's core business.

But alas...

The business of today does not grow from yesterday's growth. So we must have a reasonable expectation that the business will be able to continue on this current growth trajectory.

Obviously this question poses a great deal of problems and is prone to subjective interpretations regarding the future.

Time to pull out the crystal ball....

DirecTV has been able to execute a repeatable business model within the US, and is now growing rapidly in Latin America as well. This gives us confidence in their continued execution in the U.S. and Latin American markets, as well as potential expansion overseas internationally.

This gives us even more confidence that there is a long runway for growth in the future.

Next, we want to compare the business to its competitors, while always being on the look-out for disruptive technologies to the business model.

In DirecTV's case, we know that the satellite TV market is a very capital intensive business with only a hand-full of competitors to DirecTV (Comcast, AT&T, Dish). It is very expensive to maintain and update the satellites and equipment, and we believe they are best of breed in this growing category.

Because we believe they are the "best of breed" in the category, with better management and a more entrepreneurial minded culture, we also believe it is likely they will be at the forefront of technology updates or disruptive technologies. At the very least, they will be able to acquire these disruptive technologies with their ample cash on hand, as well as their ability to generate continued excess free cash flow with their current business model.

So, as you can see, we have shown a business with a repeatable business model and one that has a reasonable expectation of continued and sustainable growth.

Where to Find:
10-K MD&A (search growth opportunities)

Are the growth trends Secular or Cyclical?

Cyclical growth is growth that is highly correlated to the overall economy. As we know, the overall economy is subject to various cycles over time. So, we want to make sure we aren't investing in cyclical businesses during potential peak periods.

FIG: 14 Cyclical Growth Phase

Secular growth is the kind of growth we are looking for in our long-term investments. These are growth trends driven by social or demographic changes. Through these changes in consumer preferences, demand for certain products and services can have sustained growth for a long period of time.

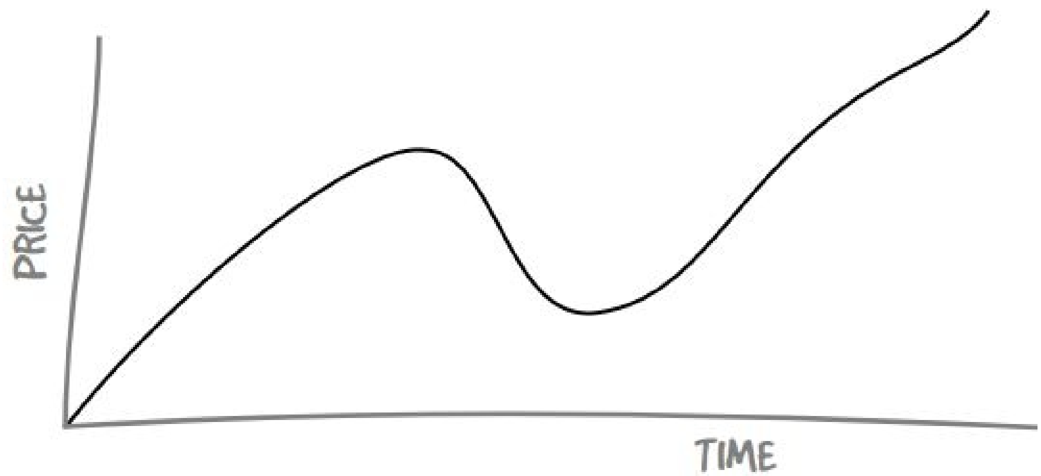


FIG: 15 Secular Growth Phase

Examples of secular trends would be the expansion of the internet and an aging population (effects spending patterns).

And secular growth doesn't mean there won’t be cyclical cycles within it. For example, Amazon is a retailer at heart but their presence and dominance online in a secular market sets them apart from other retailers and keeps them on a very consistent path as they take away market share from other retailers. Just look at this revenue trajectory, even through the great recession (fig 16).

With that said, it’s important to differentiate secular growth trends from rising commodity prices. Just because a commodity price has increased along with a business's earnings, doesn't mean it is because of secular growth. You want to always make sure that commodity producers are able to increase production of the commodity sold while keeping the average cost of production near the lows of the industry. In a commodity business, the lowest cost producer will win in the long-term every time.

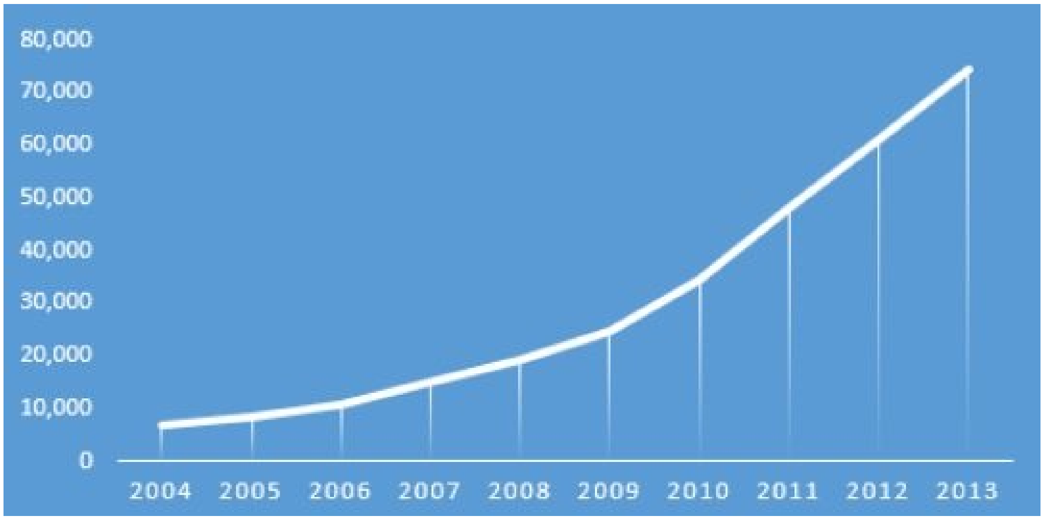


FIG: 16 Amazon Revenue Growth Trajectory

It’s crucial that we are able to distinguish between short-term cyclical growth and long-term secular growth. Great businesses within long-term secular growth industries are likely to demand a much higher premium than that of a cyclical business (and rightly so).

Secular growth businesses won't ebb and flow with the economy. Their stock price may ebb and flow with the general market or the economy; however, the underlying business should not be too correlated with the economy. A business with secular growth will also have longer lasting business cycles compared to a cyclical business.

Identifying secular growth industries and businesses is not easy.

I have tried (and studied) a number of different ways to pinpoint secular growth and I always come back to one simple question:

Is this an industry where my children or grandchildren will work?

This question (however basic and simple) forces you to see the bigger picture. It will help you visualize the future landscape of the business and how it may (or may not) be likely to change over time.

Current Secular Growth Trends

- Continued shift of consumer spending to online/mobile compared to traditional brick-and-mortar retail *(Amazon)*
- Continued move toward alternative energy solutions (solar, wind, etc.) *(Solar City)*
- Continued adoption of LNG (liquefied natural gas) as the fuel for US transportation *(natural gas producers like Exxon, Devon and Chesapeake Energy)*
- Continued demand in fast food for better quality food sources at reasonable prices *(Chipotle)*
- Continued shift from cash/checks to electronic payment *(MasterCard, Visa, VeriFone)*
- Continued growth of deepwater oil development *(Transocean, Diamond Offshore, Oceaneering)*
- Continued shift from offline hotel and airline bookings to online *(Priceline, Expedia)*
- Continued shift from traditional yellow page directory service to an online and real-time model (Yelp)

Potential Future Secular Growth Trends

- Legalized online gambling in the U.S. could have a positive impact for online gambling sites, while the brick-and-mortar casinos could take a hit *(Boyd Gaming)*
- Oil and natural gas exportation could be a game changer in the U.S. *(Cheniere Energy)*

This little exercise is all well and good, but, personally, I like to see the numbers. Assumptions are not enough for me. Not only do I want to see the numbers, I want there to be a reasonable likelihood of those numbers continuing. In trying to find secular growth trends, you need to pinpoint the actual reason for the growth, whether its baby boomers retiring, new household formation or modernization in third world countries. Once you have the reason behind the secular growth trend and why it is likely to continue, we can start to put some numbers behind it.

I have listed below a number of publications that help in gathering insights to potential secular trends:

- Advertising Age
- ESRI Business Information Services
- Euromonitor
- Mintel
- Harris and Maritz
- Trendwatching.com
- Market Research World's website
- Who's Buying Series (great resource)

Do market share projections show potential future growth?

Many analysts use the business's market share to determine whether the business has interesting growth potential. They do this by getting a total estimate of the market in the future, and then assigning the business's percentage of that market. This will give them their future growth potential that they can grow into over time.

Always be cautious of taking management's word of market share. You want to know how they have calculated market share, and then ascertain whether it's a conservative number, and why it's likely to grow over time.

If management is using a calculation other than total revenues or total earnings, I would look further into the business and its management.

Where to Find:
10-K (search for Industry or Market Size)

Is the business growing organically or through mergers and acquisitions (M&A)?

An investor should be able to classify whether a business is growing organically or through M&A. It is important to distinguish the two because a business that is growing organically will usually be considered a higher quality business. This will have an effect on the premium and/or intrinsic value of the business.

Here are some examples of businesses meeting these characteristics:

Fast food Mexican grill company Chipotle (CMG) has made virtually no acquisitions, and they have continued to grow since inception. *Growing organically* through your own cash flow is a powerful characteristic that many businesses can't do.

By focusing on the continued growth of the business, Chipotle doesn't have to worry about over-paying on acquisitions or integrating a new business. Management can focus intently on what it does best - produce delicious burritos (to the chagrin of my wife).

Pepsi (PEP), a food and beverage company, made big acquisitions in 2010 and 2011 and would be considered *a selective or opportunistic acquirer.* Usually an opportunistic acquirer is not buying a company to scale its business.

They use times of weakness and opportunity to grow their existing product lines. These businesses typically purchase businesses within their own industry and have the expertise to properly execute the integration of the new company.

This type of strategy and policy toward acquisition should sound familiar to you. It's no wonder we love these types of businesses.

It's value investing at its very core.

Precision Castparts (PCP), a manufacturer of complex metal components and products, is a *serial acquirer* and has spent between 4% and 347% of its cash flow from operations on acquisitions each year. With the average spent on acquisitions from cash flow from operations over the last few years being over 100%.

When you're playing with your cash flow levels that close to the vest, a business is leaving very little margin for error. There's very little margin of safety in this kind of investment.

When serial acquirers become aggressive in search of growth at any cost it can be incredibly damaging to the business. Unless the business is able to operate and execute the acquisition at near perfection, there are numerous risks such as using too much debt or paying too high a price for the business.

Take WorldCom for instance. In the 1990s, WorldCom was able to sustain growth rates greater than 20% for an extended period by buying up smaller telecom businesses. In the years to come, it would require them to start acquiring larger businesses in order for them to sustain that kind of continued growth in revenue and earnings.

In October 1999, WorldCom tried to do just that with a bid to merge with Sprint Corp for $115 billion. The deal was blocked in June of 2000 by the Justice Department due to concerns it would create a monopoly.

Subsequently, WordCom’s stock plummeted as the future prospects for growth disappeared (Fig. 17). The business was further emboldened in other scandals from the CEO Bernie Ebbers.

WorldCom filed for Chapter 11 bankruptcy protection on July 21, 2002. Shareholders were completely wiped out and bond holders received 35.7 cents on the dollar in bonds and stock in the new company.

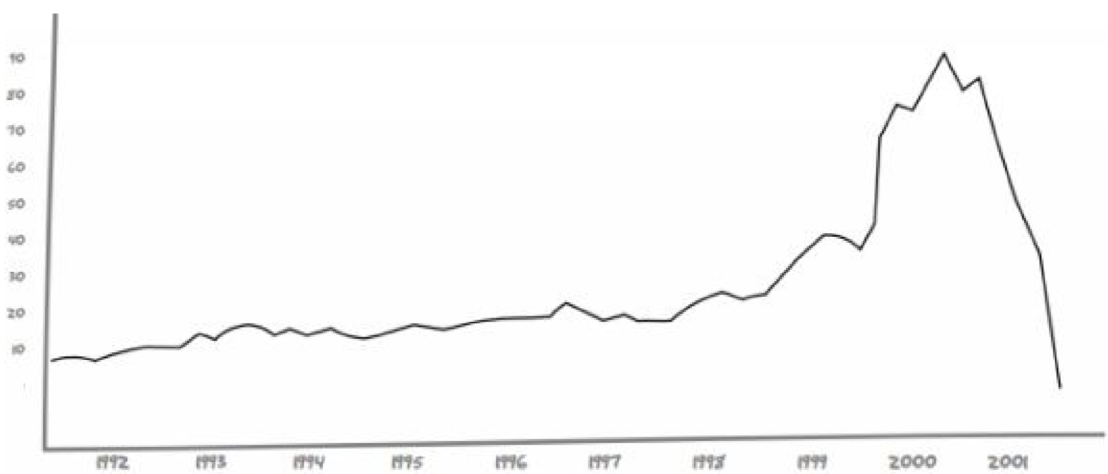


FIG: 17 WorldCom Chart, 1992-2001

By no means are these examples absolute. There are plenty of examples of successful serial acquirers, such as Tesoro, Valero, Constellation Brands, Flowserve, Chesapeake Energy, Kraft, Target, Comcast, Precision Castparts, Visa and Walt Disney.

Most of these are high quality businesses, but they would also be classified as serial acquirers because they spend a significant portion of their cash flow from operations on acquisitions each year.

<u>You need to always be aware, and consider diligently, the sustainability of growth strategies that are merely deal-driven (M&A).</u>

Another strategy to help differentiate quickly whether a business is overly acquisitive, is by *comparing the total goodwill plus intangibles to total assets from the most recent quarter*. A firm that is more acquisitive will have a higher ratio (unless they are consistently buying below book value which is highly unlikely as most businesses overpay).

Ratios below 5% are typically organic or selective acquirers. Anything over 15% would be considered more aggressive. But of course, *it's all relative to the specific situation*, the quality of acquired business, and the price paid for that business.

This ratio gives a quick and dirty assessment of what the business has done in the past. Upon further inspection you may deem the acquisitions synergistic to the business and its future growth.

This M&A ratio is a quick little trick to see how active a business was in the past with acquisitions.

REMEMBER: Just because a business is classified as a serial acquirer doesn't mean it's a bad investment opportunity. Each business should be analyzed on a case by case basis.

However, as a general rule, we want to *be cautious of growth from serial acquirers*. Serial acquirers are notorious for taking on a great deal of debt and overpaying for acquisitions. Add to the fact, the two businesses must now integrate into one business and one culture --- this can make acquisitions a risky endeavor if not executed well.

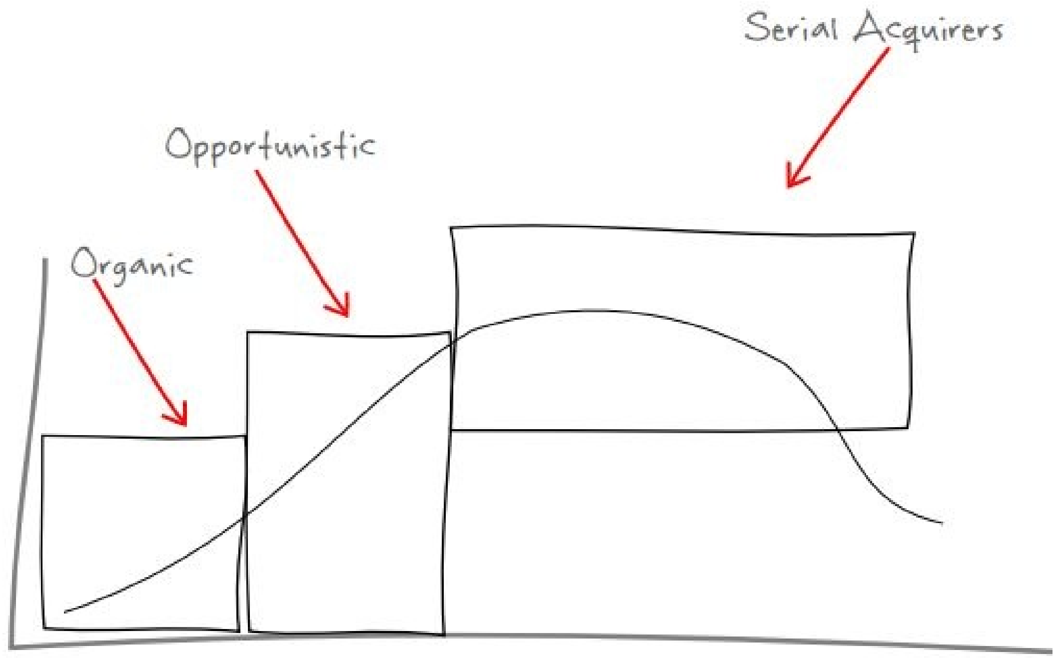


FIG: 18 Cycle Classification of Different Growth Strategies

Ideally, we want to find businesses that are growing organically while making strategic and timely acquisitions selectively.

***Where to Find**:*
Cash Flow Statement (subsection Acquisitions or purchase of business)

2)Is the business growing at an undisciplined and unsustainable rate?

This is a subject that doesn't garner much attention.

Think about it for a second...

Who wants to question or tell management that the business is growing too fast?

Not only would you be cast as an outsider, but you probably wouldn't be invited to very many Christmas parties.

Now, I am not saying to condemn management's every decision regarding growth or continued growth. However, you need to be cognizant of whether or not management is using a disciplined strategy for growth.

Rapidly growing businesses that take on excessive debt for the sake of growth are prone to substantial financial risk (especially in cyclical businesses near cyclical tops). They just don’t know it at the time.

<u>High growth doesn't equal profitability.</u> A great business should be able to provide both.

A management team should be able to produce value to shareholders in the form of reinvestment opportunities or buybacks in rapidly growing businesses. As an investor, you need the assurance from management that they are able to control and balance the growth with profitability.

All too often, investors (and Wall Street) believe that high growth businesses equate to great investments regardless of profitability or valuation. The truth is most of these high growth businesses carry a significant amount of risk. They just don't realize it yet.

Growth is great, but this doesn’t mean it shouldn’t be monitored. <u>Mis-managed growth will destroy the value of your investment.</u>

Here are some ways to determine whether a business is growing in a disciplined fashion:

Is there a proper structure in place for the business to grow?

Besides learning how to fail (and fail fast), I learned many things while creating my own business. However, there is one thing that stands out from the rest:

Your business will only go as far as the systems, and structures you have in place to help scale the business.

Most investors don't focus enough on this aspect of investing, and leave it to management to figure out. However, it's a very important component in the business's ability to grow.

It's an unfortunate reality, but many investors will glance at the book value and the cash flows of the business and say to themselves, "this looks pretty good. I think I will invest."

And they make these decisions without a proper understanding of the systems, sustainability and scalability of the business in the future.

As an investor, you want to know that a business has the proper infrastructure to support the growth (fig 18).

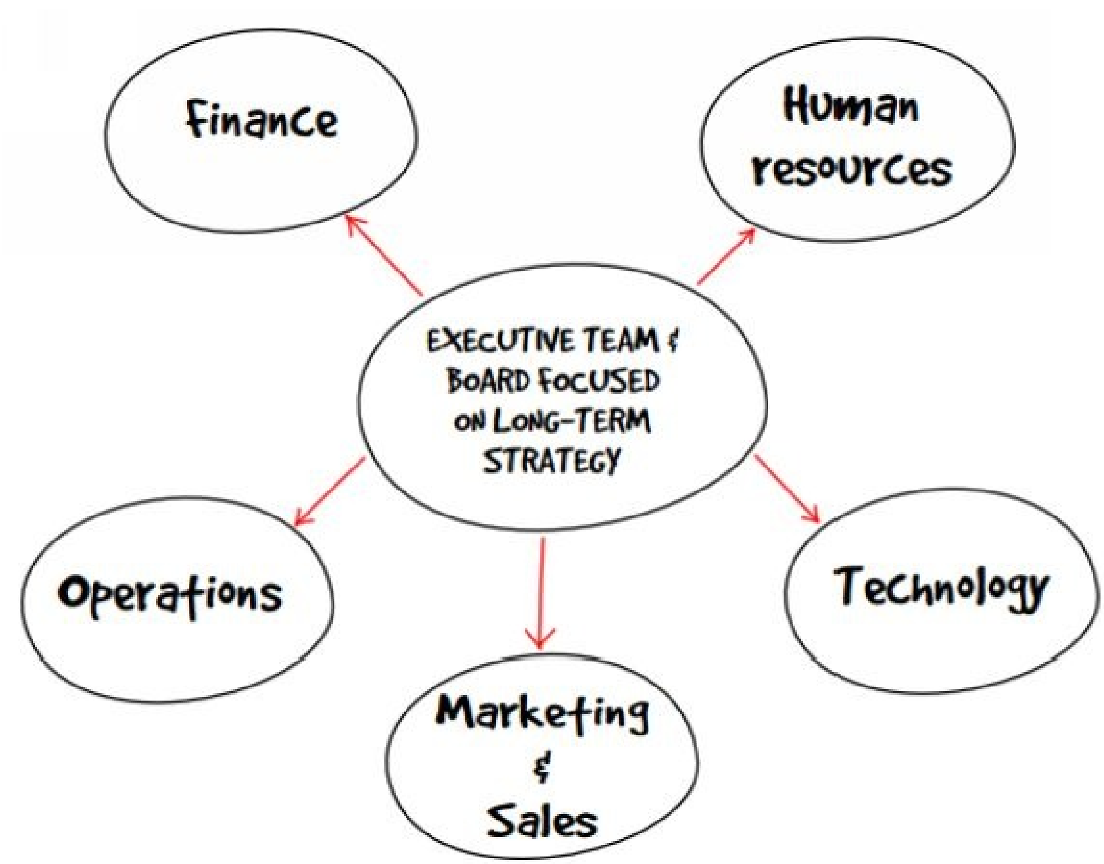


FIG: 19 Business Infrastruture To Support Growth

For example, Wal-Mart is the world’s biggest retailer. How is it that they were able to grow so rapidly with very few hiccups? For one, they had the right systems in place to accommodate that growth and scale accordingly.

When it comes to Wal-Mart, they are unmatched in regards to their supply-chain management. It is the best in the world. But it is only one part of the structure that allows them to grow without any speed bumps.

The supply-chain management combined with their efficient approach to store design, in-depth analysis of demographic profiles and incredible skill in store location and real estate savvy produces a streamlined and remarkable structure. This type of system acts as a sustainable competitive advantage as long as management is able to protect it.

Isn’t that an impressive corporate structure and system?

Is the business disciplined in choosing locations?

Normally, I am not a person that makes absolute statements. However, I firmly believe that the best businesses are opportunistic even during growth phases.

Instead of growing just for growth sake, the best businesses never feel “forced” to make decisions that are not in the best interest of the business long-term. So many management teams feel forced by Wall Street to set specific goals, regardless of the environment.

These “forced” goals could include:

- Opening a set amount of stores over the short-to-intermediate term
- Hitting certain revenue and net income growth rates
- Expanding into international markets

Think about this for a minute:

Management gets pressure from Wall Street to start increasing the growth of the business by opening new stores. The business is apprehensive, but Wall Street starts writing research reports on their concern of the business's growth prospects.

These reports cause investors to worry and uncertainty starts to creep into the investor's mind. As a result the stock price begins to fall as investors begin to sell the stock.

The management caters to the expectations around it, and the faltering share price. The business begins expanding and venturing into geographic areas that currently sport elevated rent and real estate prices (not to mention uncertainty of new rule-of-law).

When this decision is made to begin expansion, the real estate or strategy team will venture out to find locations that aren't necessarily ideal, but available. Their job is to find locations to move into quickly so they can begin the expansion. There is very little thought about anything else except doing their job and finding locations as quickly as possible for expansion.

This short-term strategy can create all kinds of issues and expenses down the road if the locations aren't a great fit. Store closures from less-than-ideal locations will end up costing the business a great deal of money in the long-term.

It’s much easier to just say NO sometimes.

Now consider the opportunistic business:

This business waits for the right situation regardless of the environment or pressure from third parties. They wait for opportunities such as that perfect location on the corner of a busy intersection for a restaurant, or that beach-front property in an area with depressed real estate prices for a hotel.

Great management teams know how to run their business properly, and care very little for Wall Street expectations and advice. The management of the business knows that if they run the business efficiently, the stock will do very well over the long-term, regardless of Wall Street coverage.

With that said, ALL management teams are not created equal. Unfortunately, there are bad management teams in control of public companies.

It’s the reason we conduct this preliminary (and simple) research. We want to ensure you are investing and partnering with great businesses and great management teams.

Whole Foods (WFM) is a great example of an incredibly opportunistic management team. CEO and Founder, John Mackey, has instilled a very strict discipline of capital allocation and quality within Whole Foods. It’s ingrained within the culture of the business.

They have very strict criteria for finding only the best locations for their stores. In fact, Whole Foods has never closed a store that it has opened since the business started over 30 years ago. And they took 10 YEARS to find the right location for their first store in San Francisco. On a separate note: John Mackey’s book, *Conscious Capitalism* is a great book and I highly recommend it.

Costco (COST) is another example. Costco is constantly criticized by outsiders and Wall Street for not expanding internationally fast enough (specifically China). They develop their management teams from within the company. They don’t hire outside management, and they never want to grow too fast outside their management teams.

For this reason, Costco only opens 25-30 new warehouses each year. They could probably open 100 each year, but they stick to this low level because they want to do it right the first time.

"Wall Street is in the business of making money between now and next Tuesday. We're in the business of building an organization, an institution that we hope will be here 50 years from now. Strategic planning is an important part of running any business and more so for businesses that operate in multiple states and countries."

James Sinegal

(Costco CEO)

In regards to China, they will be there eventually. Sinegal has mentioned previously that they are waiting for the right opportunities and trying to get comfortable with the rule of law. They will enter the Chinese market when they believe it's the right time.

Not many businesses would be willing to show that kind of discipline (especially with Wall Street breathing down their back).

These are great examples of businesses which are able to choose the right locations at the right time for the continued growth of the business.

Is the business foregoing short-term earnings for future growth?

It's common for expenses to grow at a rate faster than revenue while a business is growing. This isn't necessarily a bad thing. However, it's important for the management team to properly balance the dynamic relationship between expenses and growth.

For example, when Marriott Hotel (MAR) enters a new geographic region, it has to make very large payments up-front to purchase the land, build the hotel and secure employees and management. As you can imagine, many of these costs happen before the Marriott is able to book rooms and produce revenue.

Because of this, in the first few years it's very common to see the interest expense and depreciation creep higher. Not only will the interest expense and depreciation represent a higher percentage of the revenue, the hotel will operate at a loss for a period of time.

However, as the hotel begins to increase bookings and acquire new customers, the hotel will begin to see an increase in profit margins and cash flows (as long as it is executed properly). As you can see, this can sometimes hide the true earnings power of a business that is growing and expanding.

For example, Marriott invested a good portion of its free cash flow in new hotel openings and maintenance of properties. These expenditures hid the true free cash flows that Marriott's main business was producing.

Because of this, it seemed the business was trading at a much higher multiple to cash flows than it really was. When the capital expenditures (Capex) were cut back in 2009 from $490 million to $186 million, one year later it showed an increase in free cash flow from $151 million to $682 million as they cut back on developing properties.

Amazon (AMZN) is another prime example (no pun intended).

Amazon is relentlessly increasing its maintenance and growth Capex to capture market share as quickly as possible. When the business does mature, and growth starts to level off, you will see an incredible amount of free cash flow through to the company. In this case, I don't mind Amazon (and Bezos) trying to acquire as much market share as possible as quickly as possible in this rapidly growing industry. They have a window to not only acquire market share, but push others out of the market with their low cost, incredibly efficient model.

The only question at this point is, will Amazon be able to pull back the expenses as growth starts to level out? And will they use the excess cash flow properly?

Ultimately, time will tell on this one. However, I am not going to be the one to bet against Amazon and Bezos.

So, when looking at a growing business, you need take into consideration the effect of increased short-term expenses in order to arrive at the true earnings power of the business.

Is the business growing organically through its own cash flows?

A business that is able to grow organically through its own cash flows puts itself in a very strong financial position. This is especially important in a world that is very dependent on debt.

These days, increased debt levels seem to be the norm, rather than the exception. This increase in leverage can lead to volatile market cycles, which we've experienced quite regularly since the turn of the century.

Growing organically allows a business flexibility to take advantage of opportunities when they present themselves. Organic growth is a more stable and sustainable form of growth, so we always want to be on the lookout for these types of businesses.

The businesses that are able to grow organically are better positioned than businesses that use debt to finance their growth for a number of reasons:

1) In most cases, cash flow generated organically is a cheaper and cleaner form of capital versus issuing equity or debt.
2) Management won't be forced to make bad decisions from upcoming debt payments.
3) The business isn't exposed to the volatility of capital markets (best reason).

I'll give you a quick trick to help you guesstimate the amount of time a business will be able to grow using organic cash flow. You can do this by simply calculating the amount of time a company's cash is unavailable from working capital.

Here is the calculation:

Number of days that inventory is outstanding (DIO)
+Number of days that sales are outstanding (DSO)
–Number of days that payables are outstanding (DPO)

Or put another way…

(DIO + DSO) - DPO

Now don't be scared. It's easier than you think. You can find this information easily at GuruFocus.com or Morningstar.com.

Some may recognize this formula already. It's a simple calculation of the cash-conversion cycle (CCC). CCC simply tells an investor: once a customer pays for a product, the amount of time that money is tied up within the business before the money can be used.

Usually, businesses acquire inventory on credit and sell products on credit. This results in accounts payable and receivable. It takes time for the cash to actually hit the balance sheet until the company pays the accounts payable and collect the accounts receivable. CCC = the time in which the business actually has possession of the cash.

The higher the number of days in the CCC, the slower the business can use the organic cash flow for growth because it's unavailable from inventory or various capital expenditures.

CCC is very important for businesses in capital intensive or retail industries because of the inventory that these businesses must have on hand. For example, Ralph Lauren (RL) typically has a CCC of 90-120 days.

Conversely, CCC doesn't matter a great deal to the software, consulting or insurance industries because there’s no real need for inventory. Their products/services can be delivered instantaneously. Software companies are notorious for having CCCs of 10 days or less. This allows these low CCC businesses to accumulate and fund a significant portion of their growth with internal cash flow.

At Amazon, Jeff Bezos has been able execute the CCC at negative 30-40 days for some time now. This gives them an incredible opportunity to rapidly put that internal cash flow back into the company for reinvestment.

Isn’t that just remarkable?

3)Will the historic profitability continue to grow?

Revenue growth is great; however, in order for an investor to win at the end of the day, the business must produce profits.

For example, Jeff Bezos (CEO of Amazon) has been able to convince Wall Street that Amazon’s (AMZN) current strategy of foregoing GAAP profits now, to gobble up market share, is what's best for the company long-term. This has allowed Amazon to trade at an extremely high multiple to earnings as investors are looking way into the future for Amazon's future earnings capability. Personally, I agree with his strategy for this particular company. Each strategy is company specific.

Let’s look at some industries, and how the growth in revenue has equated to “real” earnings over the past 10 years:

The Internet Industry grew rapidly in the 90s and continues to grow rapidly today. Many of these businesses are able to create profitability and returns for their stakeholders. However, this wasn’t always the case. The early days of the internet industry looked very similar to the figure of the solar industry below (fig 21).

Many businesses were wiped out during the tech crash between 1999-2001 because they weren’t producing “real” earnings. It was very difficult to pick out who would “come out alive” in the eventual crash of the industry as a whole during those times.

Of course the current figure below looks much better for investors as long as they aren’t buying over-leveraged businesses at high multiples to earnings (fig. 20).

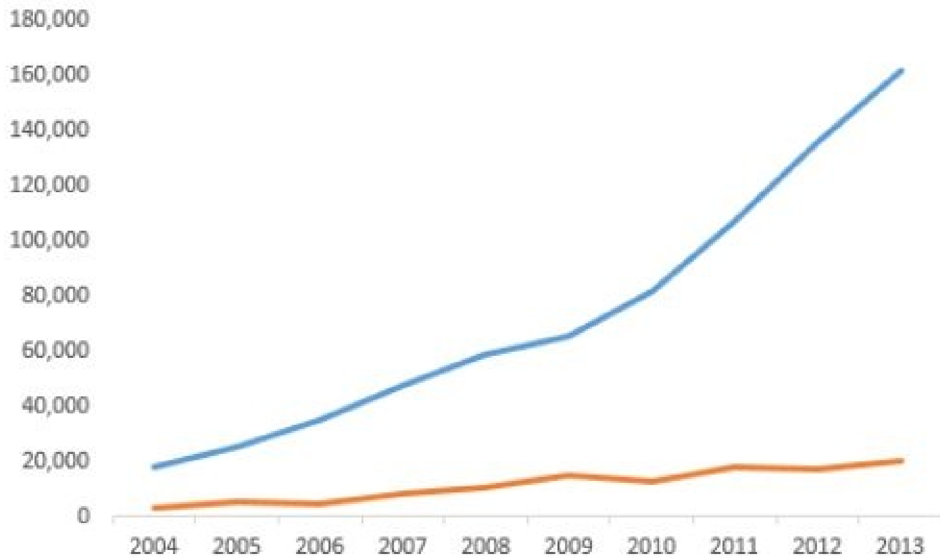


FIG: 20 Internet Industry Growth, 2004-2013
**Top 5 US Internet Companies In Revenue: AMZN, GOOG, EBAY, PCLN, YHOO*
**Blue=Revenue, Orange=Profits*

The Solar Industry is growing rapidly. The figure below shows a growing industry (fig. 21). However, it's an industry that is unable to grow profitably. An investor would be wise to pick investments carefully in this industry, while putting emphasis on high quality, free cash flow businesses with manageable debt.

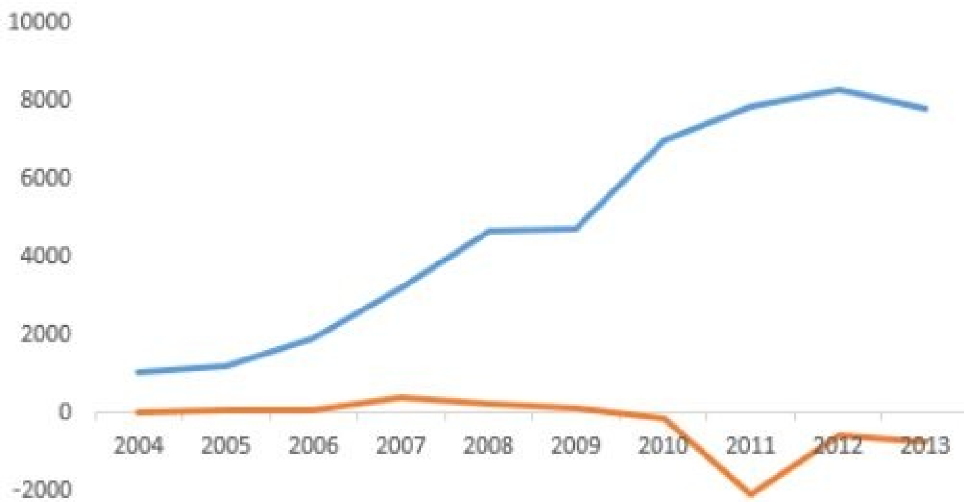


FIG: 21 Solar Industy Growth, 2003-2013
**Top 3 US Solar Companies In Revenue: FSLR, SPWR, SUNE*
**Blue=Revenue, Orange=Profits*

The Airline Industry is going through a very interesting transition. It's an older industry compared to the Internet and Solar industries. And until recently, the Airline Industry, as a group, had produced no "real" earnings.

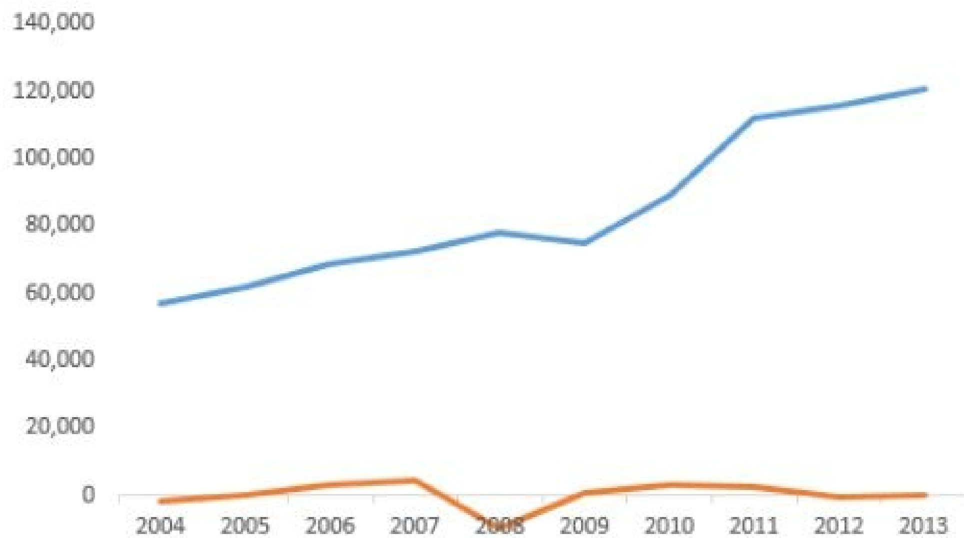


FIG: 22 Airline Industry Growth, 2003-2013
**Top 4 US Airline Companies In Revenue: AAL, UAL, DAL, LUV*
**Blue=Revenue, Orange=Profits*

As you can see in the figure above, there appears to be a shift occurring, and the first investors to recognize the shift in airlines producing FCF, were the ones that were able to establish positions before anyone else (fig. 22).

The airline industry, which was once extremely fragmented and competitive, is now controlled by a select few companies, after the recent consolidation in the sector. This allows each of these businesses a little more pricing power and profitability (as long as they don't screw it up).

Legg Mason's Bill Miller was among the few who first observed this shift. There was an immense difference between investor perception and economic reality. As a result, he was able to take advantage of the depressed stocks prices in airlines, and profited handsomely while others were still in disbelief.

General Observation: Maybe it's better to wait for pull back opportunities in growth businesses where there is a divergence between growth and profitability. It's better than trying to chase the big growth stories at expensive multiples to earnings. It seems to be a theme that plays out over and over again in the stock market.

Investors constantly get lured into buying high and selling low.

Historically, the railroad industry, the airline industry and the internet industry all had periods of investor euphoria, even while the industry as a whole produced no 'real' earnings and straddled themselves in debt.

Of course, the devil's advocate would say, "they are rapidly growing businesses…they were putting the money into the growth of the business."

And to that, I say, "Why can't a business do both: produce growth in revenue, while showing they can be profitable, as well?"

This is what great businesses do. They are able to balance the growth trajectory with profitability. This is profitable for all stakeholders.

Will the airline and solar industries ultimately figure it out like the profitable railroad or internet industries?

Time will tell.

4)What is management's incentive to keep the business growing?

Always check to make sure growth is directed at the core business. All too often management's incentive structure is tied to revenue growth of the business.

If management can't find growth opportunities within its own business segment, it will look elsewhere to other industries where they lack specific knowledge or expertise. This could have a potential negative effect down the line, so it is something we want to be on the lookout for during our research process.

For example ITT Corp (ITT), a diversified global manufacturer of highly engineered industrial products and high-tech solutions, ventured into multiple sectors and industries throughout the 60s and 70s which culminated in the business purchasing wide ranging businesses from hotel and gaming businesses to insurance and manufacturing.

As you can imagine, this may help to support revenue levels for a period of time. However, over the long-term these different business segments become distracting to the overall business.

ITT finally spun-off the last of its non-core assets in 2011 with the spin-off of Xylem (a provider of water and wastewater solutions) and Exelis (a diversified global aerospace, defense and information solutions company).

Each of these businesses will do much better on a stand-alone and focused foundation, rather than a hodgepodge of different businesses.

REMEMBER: When you buy high multiples of earnings in the form of P/E ratios or Cash Flow ratios, you are paying for those continued expectations.

Premium earnings multiples will normally be attached to growing businesses. It makes sense because investors are willing to pay more for high quality growth businesses.

The problem comes into play when you pay “too high a price” for those earnings, essentially giving yourself no margin of safety.

For example, let’s say you pay up and purchase a business at a P/E ratio of 25 that earns $1 per share. If the company doubles its earnings to $2 per share, you essentially only paid 12.5 times earnings for next year.

The stock price will drop as growth slows or investors are unwilling to pay a high multiple for the business. This is exactly why we want to avoid paying too high a multiple for any business (even moat businesses).

For example, the stock price of Apple (AAPL) is an interesting case study in investor and human psychology. It also shows how reality doesn’t mean a great deal to the average investor if growth is slowing, regardless of the valuation or staying power of the business. Take a look at the figure below (fig. 23).

FIG: 23 Apple Chart 2012-2015

	2010	2011	2012	2013	2014
Revenue	65,225	108,249	156,508	170,910	182,795
Revenue %	*52%*	*66%*	*45%*	*9%*	*7%*
Net Income	14,013	25,922	41,733	37,037	39,510
Net Income %	*70%*	*85%*	*61%*	*-11%*	*7%*

FIG: 24 Apple Revenue and Net Income Growth, 2010-2014

Investors were willing to pay up to 20 times earnings during an increasing growth phase for Apple. But they were unwilling to buy the stock (or sold the stock) as growth slowed pushing the P/E of Apple to a low of 9.5 (very low for a high quality business).

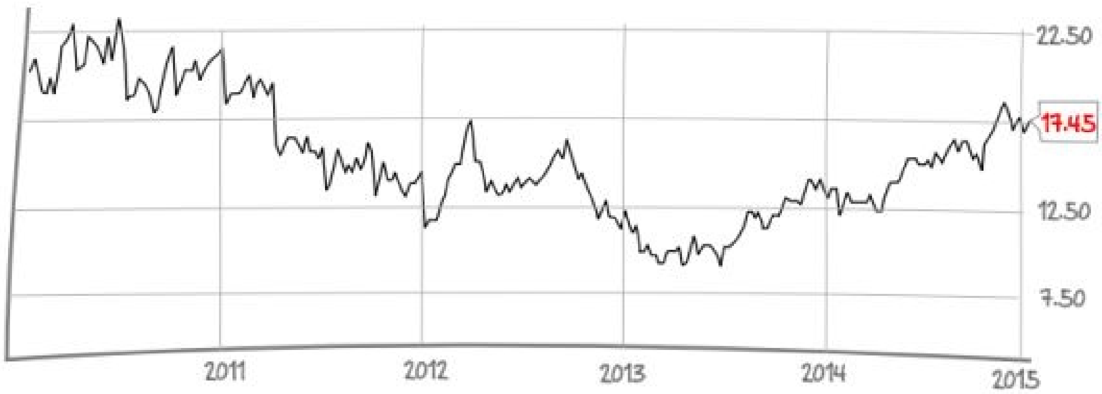


FIG: 25 Apple P/E Ratio, 2011-2015

But it gets better when you go through the MECOM™ Method. In actuality it was much better than just buying a great business at 9.5 times earnings. At the lows for Apple in 2013, you had the opportunity to purchase a…

- **M -** High quality business with established, ecosystem, network effects and an incredibly loyal customer base,
- **E -** Trading at around 6 times earnings when you subtract the cash on the balance sheet,
- **C -** New product lines and products in the pipeline, activists involved (Ichan, Einhorn),
- **O –** Fortress Balance Sheet with low debt and ample amount of cash on the balance sheet,
- **M -** And a capable and shareholder friendly management (hand-picked by Steve Jobs, opportunistic buybacks, divi program implementation)

You see what we just did there…?

Yes, that was the MECOM™ Method in action. This "quick and dirty" analysis helps you get to the most important elements of investing success. That's how powerful it can be to quickly determine whether businesses have the potential to be successful investments.

When you can break down the business like this with the MECOM™ Method, it starts to look much easier. At the very least, it allows you to look at an investment objectively when everyone else loses hope or believes the business is dead.

A simple process like the MECOM™ Method helps us see the important qualities for investment, and it allows an investor to make objective decisions to act opportunistically when the time calls for it.

The MECOM™ Method helped to breakdown an opportunity in a high quality, recurring revenue business with an earnings yield of over 15%, and very little risk on the balance sheet.

This is a perfect example of how investor irrationality can provide opportunity for us. The MECOM™ Method helps us determine whether it's a legit investment opportunity, quickly and efficiently. When the stock price was rising to new heights everyday (during the growth phase), investors were more than willing to pay upwards of 20 times earnings. However, investors were no where to be found when the stock price was dropping, even though the business was still growing (albeit at a slower rate). Investors could’ve taken advantage of the market panic, and purchased the business at lower risk levels with a significant margin of safety.

Of course you have the other side of the spectrum too. The business could continue to grow its earnings at an incredible rate. Amazon is the first company that comes to mind as an example for this type of business. Although this is rare for an extended period of time, there are a few out there.

Although there isn’t a margin of safety in this kind of investment, the growth of the business allows an investor to get away with it for the time being. So long as the business continues to outpace growth and business expectations.

Ninety percent of what passes for brilliance, or incompetence, in investing is the ebb and flow of investment styles. Since opportunities by style regress, past performance tends to be negatively correlated
with future relative performance.

Jeremy Grantham

REMEMBER: <u>All businesses will eventually slow in growth.</u> If you were able to catch the early growth stage of the business, great job. However, be cautious during times of stock market (or individual stock) euphoria, and be careful when purchasing high growth businesses after years of outsized growth and stocks at all-time highs.

These kinds of stocks are priced for perfection, and they are more prone to dramatic changes in business operations and stock prices at anytime (more than likely to the down side).

In 2002, Professor Cyrus Ramezani conducted a study of over 2,000 public companies by analyzing the relationship between growth and shareholder stock prices. His conclusions were very interesting. Of the companies with the fastest revenue growth (a 10-year period of 167% avg annual sales growth), they produced worse share price returns versus their slower growing competitors (avg growth of 26%).

Essentially, the hot and popular businesses could not maintain their momentum as shareholders were unwilling to purchase at such elevated levels or growth rates started to slow. Their stocks underperformed as a result.

<u>Be careful about paying for businesses that are priced for perfection.</u>

Is There Future Growth In The Industry?

"When a surfer gets up and catches the wave and just stays there,
he can go a long, long time…"
Charlie Munger

Charlie Munger refers to this mental model as "surfing."

There are great advantages to being the "early bird" or "top dog" of any industry-wide growth phase. These "surfing" industries or ideas should be no-brainer type of moments. However, it takes an understanding of how big the product or industry could become before you are able to visualize these types of scenarios.

"But why is industry analysis so important?"

"I thought we were value investors. We don't care about anything but the underlying business…"

It's true. The underlying fundamentals of the business will take precedence in our analysis (and ultimately the decision to invest). But this shouldn't keep a value investor from briefly analyzing where the industry cycle may be presently. Industry cycles and dynamics can have an effect on the underlying business.

So, it only makes sense to make sure it's part of the process. Whether it's a significant portion of your analysis or not is completely up to you. Below we will go over some key points to focus on to help you pinpoint the areas that are most important.

Each industry has its own set of standards within the MECOM™ Method. These are mental models that you will pick up as you invest across different industries.

5M™ and the MECOM™ Method will get you 80-90% of the way there. But it's not a panacea. The rest depends on your determination and analysis of the finer points to your investment.

For instance, book value doesn't matter a great deal to a technology company that doesn't need large physical assets to generate excess cash flow. If you are comparing apples to oranges, the analysis is moot.

You want to always make sure you are comparing apples to apples.

Another reason we want to pay attention to the industry is because we want to make sure there is a high probability that the industry as a whole will continue to grow at a reasonable rate over the foreseeable future. This provides an added margin of safety to your investment, as long as management is able to execute on a strategy to take advantage of the industry-wide growth movement.

An investor should always be looking for those "surfing" situations by investing in the best business within that industry. If an investor is able to pinpoint just a couple of those opportunities in his/her lifetime, they can expect to profit greatly.

This is an incredibly powerful model.

Where to Find:
http://www.reportlinker.com/ (FREE) Our Favorite!!!
http://www.investopedia.com/features/industryhandbook/ (FREE)
http://www.valueline.com/Stocks/Industries.aspx (FREE)
http://www.hoovers.com/industry-analysis.html (PAID)
http://www.firstresearch.com/ (PAID)

Are There Management Catalysts?

"Cheap prices can set the stage for share price appreciation. However, cheap prices, by themselves, are not reason or justification enough for us to invest."
Lukas Neely

Most of the time, the major timely catalysts are initiated at the discretion of management or board of directors. They include:

- Liquidations (orderly, fire-sale)
- Spin-offs or Divestitures
- Recapitalizations
- Major Asset Sales *(includes merger-arb)*
- Buybacks
- Dividend Initiation or Increases
- Activist Involvement

Liquidation is the only catalyst that brings about full value realization.

There has been a big push lately regarding activist investors purchasing controlling stakes in businesses. This gives them voting control or influence of the company's stock, which allows them to elect a significant portion of the board of directors. Essentially, these activists take the potential catalysts activation into their own hands.

Investors such as Carl Ichan, Bill Ackman, Dan Loeb, Jeffery Ubben and Wilbur Ross, purchase large stakes in companies and convince shareholders that their plan for value creation should be implemented.

The involvement of activists is not a catalyst by itself --- it's the plan and the actions of the activists that bring the issues and problems to the surface in a very public manner. This can cause fear and action in management.

And if certain issues are not fixed over a period of time, the activists may begin to take steps themselves by nominating board seats and pressuring for new management. This can act as a catalyst if the right manager is put at the helm.

Either way, you can begin to see an appreciable movement in stock prices when activist investors provide a simple and realistic plan for value realization.

Are There Business-Driven Catalysts?

Catalysts can also come in the form of a business turnaround too.

A business turnaround can create positive feedback loops which will include positivity towards the stock and the company, as well as potential inclusion into a major index if the business meets certain business metrics.

For example, Boston Scientific (BSX), a medical device company, was left for dead between 2011-2013. Slimmer hospital budgets combined with increased competition in the medical devices industry helped to flat line revenue growth for BSX.

As you can see in the figure below (fig. 26), using very conservative discounted cash flow assumptions, BSX was trading well below its intrinsic value.

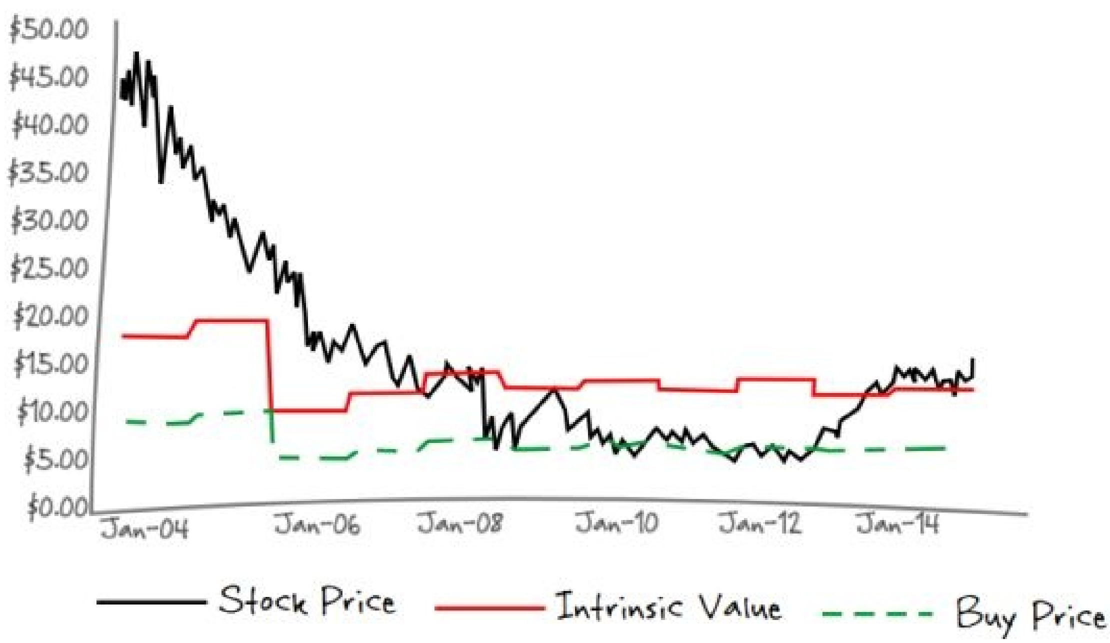


FIG: 26 Boston Scientific (BSX) Chart, 2008-2015

So what changed?

For one, the perception of the business changed to the market.

However, the actual cause of that change was the turnaround in the fundamentals of the business.

Investors ignored the products in Boston Scientific’s pipeline for neurotechnology. Because Boston Scientific constantly came in under revenue and profit expectations, the market completely overlooked the pick-up in growth for the cardiac rhythm management products division within Boston Scientific.

Simple surveys to customers, research and industry reports on these products would have alerted an investor to the potential success and growth that these sectors were experiencing.

To drill down on the hard numbers, here are some metrics to focus on to help pinpoint the potential turnaround of a “down-and-out” business:

- Change from negative to positive FCF
- Increase in FCF
- Increase in profit margins
- Increase in revenue
- Improving efficiency ratios (CCC, DSO, DPO, DSI,)

Focus on these key metrics, and you may just spot a turnaround before anyone else.

In Boston Scientific’s case, FCF bottomed out at $53 million in 2010 during its trouble period, only to increase again to $704 million in 2011, and increase again to $1,034 million in 2012. All of these signs were present in the turnaround of the business, even as the stock fell below $5.00 per share as you can see in the figure above. The stock hit a high of $13.76 in 2014.

This was a tremendous time to take advantage of an opportunity that the market was unwilling or unable to accept. In addition, Boston Scientific was trading at a significant discount to its conservative estimate of intrinsic value, which gives an investor a margin of safety in case things got worse for the business.

Sometimes it just takes a while for the market to actually believe the turnaround and jump on board. Ultimately, that’s the reason investors should enjoy the search for turnaround businesses.

Individual investors are faster moving than the big behemoth funds. Most institutional funds need acceptance from a team of fund managers or board members, which can take days or weeks.

If an investor spots a turnaround with low risk, he/she is able to take advantage of the opportunity, and establish a position quickly without the need for committee acceptance.

Investors search for the turnaround of a business because it can have larger, more pronounced returns which can be weighed in multiples of the money you invest.

However, there is a catch-22…

<u>Turnarounds are incredibly difficult to pin-point or predict</u> with any high degree of certainty (even for the seasoned pro).

In addition to the focus points above, an investor should look for two main characteristics in potential turnarounds to help minimize risk. This will give you a margin of safety in your investment:

- A business trading below liquidation value, and/or
- Favorable earnings power 3-5 years out

It's important to note: There is a difference between a business trading below liquidation value on the open market, and a business that is involved in Chapter 7 liquidation proceedings. Chapter 7 liquidation investments normally brings about complete value realization in a relatively orderly manner.

However, businesses trading below liquidation value outside of Chapter 7 liquidation proceedings, can take longer to realize full value without turnaround catalysts in place. Businesses trading below liquidation value in the stock market are subject to the whims of the market.

Combining both a turnaround situation with a company trading below its liquidation value provides a powerful catalyst combination for the patient investor.

You will gain confirmation of the potential turnaround when the business begins earning FCF on a regular basis, as well as seeing efficiency metrics improving. By the time this is realized by the market, the stock may be moved significantly towards its intrinsic value. The great aspect of turnarounds is that there is usually a longer runway for stock price appreciation.

As you may have noticed, bankrupt businesses are a subset of turnarounds. The characteristics for investment are the same. I am looking for businesses trading below liquidation value and favorable earnings over the next 3-5 years.

We are always on the lookout for great businesses with sustainable competitive advantages at a good price. However, there are instances when the odds are in your favor to invest and potentially earn multiples of your investment if the turnaround takes hold.

Turnarounds that have the potential for at least 3-5x your initial investment could be worth further investigation.

Where to Find:
www.TheTurnaroundLetter.com

Are There Supply/Demand Catalysts?

And this is the section where the true value investors will write to me in scorn… I can't help it, and here's why.

I imagine it's my early influence of being trained as an equity, derivative and merger-arb trader before falling in love with value investing. Supply/Demand catalysts are not fundamental or business based, so they are often cast aside by traditional value investors as "Voo-Doo" or a waste of time.

In my experience this couldn't be further from the truth.

I firmly believe that <u>there are cycles and imbalances that are readily apparent in stocks (just as in life) that an investor can use as another tool to help increase his/her margin of safety.</u>

Supply/Demand Catalysts fall into two main categories:

1) Short Squeeze
2) Volatility Squeeze

A **Short Squeeze** is a situation or event where a heavily shorted stock or commodity moves sharply higher because short sellers close out their positions by buying back their short positions. This can provide upward pressure on the stock.

For example, let's say a company that we classify as a high quality business goes through a difficult period. The recession hit them hard, and market participants begin to sell the stock short in hopes of reaping returns as the stock falls.

The stock falls from $25 to $10 per share. Short sellers are ecstatic, but the company seems to be improving operationally. The revenues are stabilizing and cash flows are starting to pick up. Margins are starting to advance, and efficiency ratios are nearing the best in the industry.

The stock begins to slowly increase in price. The stock soon rises 25% over a course of a month, and the short sellers start to become nervous.

The short sellers start to liquidate and cover their short positions by purchasing the stock they shorted. This kind of activity can "feed" on itself further to the upside if there are enough short sellers in the stock.

So how do we find these heavily short stocks with potential for short squeezes?

There are two measures an investor can use to help identify potential short squeezes:

1) Short-Interest

Short Interest is the percentage of total shares sold short versus the total shares outstanding of the business. The higher the number the better as a catalyst for investment.

2) Short-Interest

Ratio Short-Interest Ratio is the total number of shares that are sold short divided by the average daily trading volume. It represents the number of days it would take for short to finish buying back all the shorted shares. The higher the number the better as a catalyst for investment.

**You will want to cross reference your watchlist with businesses that are heavily shorted to see if there may be potential.*

REMEMBER: High short-interest by itself is not a reason for investment. It's just another catalyst or tool an investor can use to help increase the margin of safety in a high quality investment.

Where to Find:
www.ShortSqueeze.com

A Volatility Squeeze is a situation or event that occurs after a period of low volatility. Many traders have heard of Bollinger Bands. Most charting software includes Bollinger Bands because they are used by many traders.

John Bollinger created the Bollinger Bands and he says his bands are "driven by volatility, and the Squeeze is a pure reflection of that volatility." Bollinger bands are comprised of a 20 day moving average (DMA) and two bands (2 standard deviation above and below the 20DMA). See figure 27 below.

Stocks (just like humans) don't move in a linear fashion. It takes time for emotional pain and suffering to play out as stocks decrease in value. There are cycles to human emotion and action. Bollinger bands can help investors to see the underlying market psychology a little more clearly.

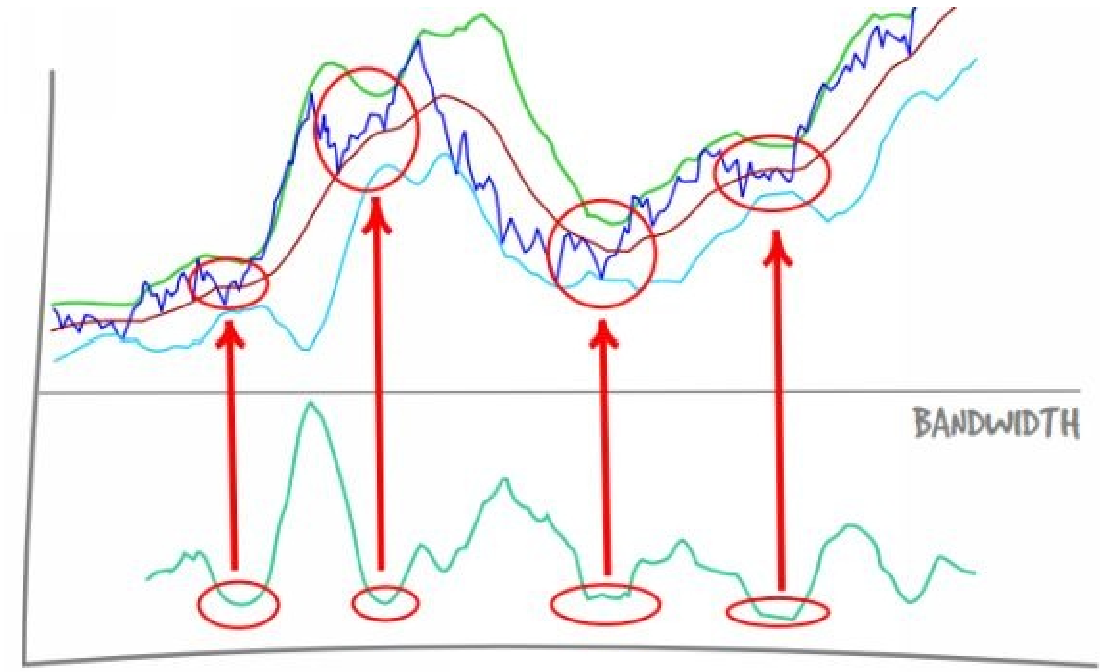


FIG: 27 Bollinger Band Example, Apple 2012-2015

As you can see from the figure above, when Apple's Bollinger bands squeeze tighter together, there was a fairly significant move soon after.

The line above the chart with the red circles pinpoints areas of low volatility. Which usually sets the stage for increased volatility, or *volatility squeezes.*

The only problem….

You don't know the direction of the potential move. That's why we always look for high quality businesses to invest in at depressed prices. It helps to increase the probability that the upcoming move will be to the upside if we purchase at large discounts to intrinsic value.

Like high short-interest stocks, we only use potential volatility squeezes as an additive catalyst. However, my experience has shown these events to be significant factors nonetheless. This chart above is just one of many examples.

**Hat tip to Dan FitzPatrick for teaching me about Bollinger Bands. He was trained by John Bollinger himself. And he teaches what he knows everyday to help others find a path to investment success. He truly is one of the good guys in the industry. Thanks Dan!*

A Supply/Demand Catalyst is yet another tool to help skew the risk/reward profile in our favor.

Where to Find:
www.BollingerOnBollingerBands.com
www.StockMarketMentor.com

Step 4 of MECOM™: Obligations

Does the company establish proper leverage and debt control?

This man took a great deal of condemnation from investors and the general public for his purchase of American International Group (AIG) after its bailout and at the depth of the financial crisis. He was ridiculed by other investors and questioned by the financial media. I guess we saw who had the last laugh.

He began establishing a large position in AIG in March of 2010 after it was recapitalized by the U.S. government. He continued to add to his position in 2011 as the stock plummeted from $60 to a low of $20 per share.

That man is none other than Bruce Berkowitz of Fairholme Funds.

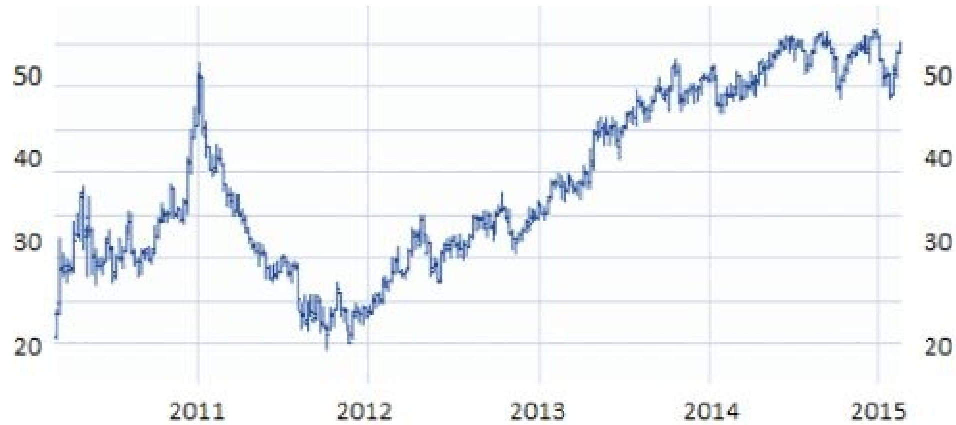


FIG: 28 AIG Chart, 2010-2015

Currently, AIG is an extremely large position in his portfolio, upwards of 40% of his portfolio.

So, what gave him the confidence to purchase a business like that -- with the constant public lambasting, government oversight, and stock prices plummeting?

Certainly there were other factors for his investment in AIG; however, the new fortress-like balance sheet, and bevy of high quality assets on AIG’s balance sheet gave Berkowitz the confidence to accumulate even more shares at lower prices. This margin of safety allowed Berkowitz to decrease the average price paid of his investment in AIG. Thus, increasing his ROI.

With the bad assets and liabilities off AIGs balance sheet, Berkowitz saw a systemically important business with high quality assets, underlying business trends improving, and a business trading well below its liquidation level.

If you are correct about your investment thesis, and the stock trades to a lower level, why in the world would you not take advantage of lower prices and buy more? If you know nothing about the business, and its staying power, it can be very difficult to do.

<u>Businesses with strong balance sheets can give investors the confidence to buy more of their favorite ideas when it seems the world is coming to an end.</u>

Lower Price Paid = Higher ROI

In this section, we will determine whether a business has a "fortress-like" balance sheet or not.

All too often, the balance sheet can mean the difference between a bump in the road or bankruptcy. It could even mean the difference between "paper" losses or permanent loss of capital.

An investor who knows the difference between a strong and weak balance sheet will be a step above the average investor or market participant.

Most investors pay very little attention to debt levels, so long as the business continues to grow at a great rate. This is a mistake that can cause permanent loss of capital if you aren't aware.

Strong balance sheet businesses have the ability to take advantage of opportunities across numerous economic cycles. The same cannot be said for highly leveraged businesses.

In determining reasonable debt levels of the business, you need to determine whether the cash flows are predictable enough to make debt payments. It’s important to note that we want to make sure there is a margin of safety in the debt-to-cash flow levels too. If the cash flows decline we want to give ourselves a little cushion in case we were wrong.

The best investors try to kill the company!

Yes, you read that correctly...We Want To Kill The Company.

Whether an investor wants to admit it or not (consciously or subconsciously), he/she wants to find a reason to say “NO.” As an investor, you absolutely should.

“We spend a lot of time thinking about what could go wrong with a company… We try every which way to kill our best ideas. If we can’t kill it, maybe we’re on to something.”

Bruce Berkowitz

Great investors go through this activity because if they can't kill the business, then they know they may be onto something (this is more prevalent during times of negative perception to a business or industry).

And one of the easiest ways to kill a business is with excessive obligations or debt. Nothing kills a business faster than debt.

This is the reason we want to focus on a few keys areas to determine whether a business has adequate leverage and debt control.

Here are some tips and tricks to help you determine whether a business has a "fortress-like" balance sheet:

Moderate-To-Low Levels Of Debt?

Businesses with limited amounts of debt have many advantages over their competitors.

Debt that can be paid back in 2-3 years with current cash flows and a business with very little long-term debt would qualify as limited amounts of debt.

Here are the 2 main advantages of strong balance sheet businesses:

1)Allows the business to be opportunistic

During periods of market corrections (recessions), leveraged businesses have a difficult time taking advantage of the opportunities around them. In contrast, businesses with strong balance sheets are able to increase competitive ground, and advantages over their higher leveraged competition.

Businesses that are able to finance their own operations, or have ample cash on the balance sheet, are better able to make opportunistic acquisitions, buy back stock and/or increase marketing and ad budgets to help them grow.

Example of Increasing Marketing & Sales:

During the 2000 recession, Target (TGT) increased its marketing and sales budget by 20% compared to pre-recession levels. It didn't stop there though. An increase in capital expenditures by 50% helped to grow the number of stores it operated from 947 to 1,107, and almost tripled the SuperTarget stores from 30 to 88.

As a result, Target was able to grow revenue by 40% during the recession. Many of Target's competitors were unable to take advantage of such opportunities because the balance sheet gave it no flexibility. In addition, profit margin increased from 9% to 10%, which helped to grow profits by 50%.

How's that for being opportunistic during a recessionary period?

Example of growth and maintence CAPEX:

Another example during the 2000 recession was T.J. Companies (TJX), operator of T.J. Maxx and Marshall stores. This discount retailer didn't "tuck-tail" and run during the down turn. In fact, they expanded. And the strength of their balance sheet allowed them to add 300 stores at the start of the recession (2000), to a store base of 1,350 stores at the end of the recession in 2002. Capex basically doubled and the square footage increase almost 25%.

This helped TJX to growth earnings at a far better pace than its competition during and after the recession.

These types of actions go beyond just helping a business maintain market share, it helps a business to grow and "gobble-up" market share when (or if) the business eventually comes out of a despondent period.

2)Less risk of insolvency (bankruptcy)

The durability factor!

This is a very important advantage considering it helps you to sleep much better at night. <u>Less risk of insolvency means it will be very difficult to kill the business.</u>

Case Study of Business Using Debt Conservatively: Costco (COST)

Costco is one of the leading retailers in the U.S., and expanding globally. It's a great example of a business that uses debt conservatively. Virtually all of Costco's long-term debt is investment grade, fixed rate at very low interest rates. As a result, increases in interest rates should have minimal effect on the business.

Costco also staggers the due date of the debt repayments, so they are spread out over time. This helps to minimize refinancing risk.

This is an interesting case study because Costco doesn't normally use long-term debt to expand its business. However, Costco just recently embarked on long-term strategy to grow its warehouse base. This essentially tripled the long-term debt on its balance sheet. So this makes for a great example to help us understand whether this business *still* has a strong balance sheet. This analysis will give us the assurance we need that this business will *last* through various cycles.

Now, normally this would be a concern.

However, given management's history of frugality and tactical acumen, this isn't necessarily a bad thing. Especially when you begin to look at the kind of debt that Costco used to help finance the build-out of its warehouses.

We will use Costco's debt ratios to help us determine whether the business has a "fortress" balance sheet and has the ability to pay its obligations.

There are two types of ratios to help investors determine the strength of a business's balance sheet: *Coverage Ratios* and *Static Ratios*. Let's go over each individually.

Coverage Ratios help an investor measure the ability to meet financial obligations. Normally, the higher the coverage ratio, the better the business will be able to meet its obligations to lenders. This analysis helps greatly in ascertaining the business's current financial position. Each ratio is ranked in order from most important to least important.

The two most common, and useful coverage ratios include the Interest Coverage Ratio and EBITDA Coverage Ratio:

Interest coverage ratio is used to determine the business's ability to pay interest on outstanding debt. It is calculated by dividing earnings before interest and taxes (EBIT) by the interest expense.

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Expense}}$$

An interest coverage ratio below 1 (or around 1) tells an investor that the business may be in trouble and is having issues generating sufficient earnings to satisfy interest expenses.

In Costco's case, the interest coverage ratio is 30.62. As you can see, Costco is well within the safe zone and should have no problem being able to satisfy any debt obligations.

EBITDA Coverage Ratio is mainly used by leveraged buyout firms (LBOs). Essentially, this ratio is the same as the interest coverage ratio except it helps an investor see the potential for the business to borrow more or see the potential for buyout offers (higher the better).

$$\text{EBITDA to Interest Coverage Ratio} = \frac{\text{EBITDA}}{\text{Interest Payments}}$$

Similar to the interest coverage ratio, a ratio around 1 sets off a major red flag. This ratio doesn't include depreciation, so any ratio closer to 1 will be more problematic than just the interest coverage ratio. Depreciation is a real cost of doing business, and should track the maintenance of current business operations. Leaving depreciation out of your calculation for debt obligations is more aggressive.

"People who use EBITDA are either trying to con you or they're conning themselves. Telecoms, for example, spend every dime that's coming in. Interest and taxes are real costs."

Warren Buffett

As a general rule, investors should stay away from businesses that use EBITDA as a metric to dress up financial statements. A heavy dose of skepticism is warranted towards businesses or analysts that use EBITDA in their financial reporting and analysis.

We state EBITDA here only to help an investor in his/her analysis of a business being able to meet debt obligations. However, it should never be used in the analysis or valuation of the business. As Buffett says, depreciation, amortization, interest and taxes are real costs!

Costco has an EBITDA Coverage Ratio of 40. Well within the safe zone.

Important To Note: These two ratios give you an idea of the coverage ratios of a business at a present moment in time for the interest of the debt. It does not include repayment of that debt.

Therefore, it's important to perform this analysis for future obligations and amortization of the debt as well. This will give an investor a better idea of the financial situation.

For example, look at the figure below of the future coverage ratios taking into consideration future interest expenses and debt amortization with current cash flows (fig. 29).

	2016	2017	2018	2019	Thereafter
Interest Coverage Ratio	2.48	2.93	2.70	33.54	2.28
EBITDA Coverage Ratio	3.35	3.95	3.64	45.20	3.08
Maturities of Long-Term Debt	1,296.00	1,099.00	1,191.00	96.00	1,411.00
EBITDA	4,339.00	4,339.00	4,339.00	4,339.00	4,339.00
EBIT	3,220.00	3,220.00	3,220.00	3,220.00	3,220.00

FIG: 29 Future Coverage Ratios, Costco, 2016 and beyond

As you can see, the coverage ratios show a business well within its ability to repay the interest on debt obligations. However, they didn't take into consideration the repayment of that debt in the future.

Even with all of that said, Costco still has an incredibly strong balance with its ability to meet current and future debt payments. It is able to accomplish this because of its stable and consistent earnings generation.

This gives the business plenty of flexibility to pay back the obligations, and still grow the business. And we haven't even discussed the five billion dollars of cash on the balance sheet.

This is just another trick I use to give further margin of safety in a business being able to satisfy debt obligations.

REMEMBER: An investor gives themselves a better ability to determine a business being able to satisfy obligations with real cash flow. Using Cash Flow from Operations (CFO), instead of EBIT and EBITDA, can provide a more reliable and steady measure than earnings that can be easily manipulated.

An investor would be wise to give themselves a margin of safety in these calculations, as well. Each industry, and each business for that matter, will produce cash flows over different cycles.

As a general rule, the more cyclical the business, the higher coverage ratio an investor should demand. Cash flows in cyclical businesses are more volatile in nature. The higher coverage ratio gives an investor a larger margin of safety, just to be cautious.

For example, in commodity-type businesses, an investor may want to demand more than 10 times coverage. And in industries like utilities or healthcare, an investor may want to demand only 5 times coverage. It will be specific to the business and industry.

Static Ratios help an investor measure the ability of a business to pay back its obligations. There are four main types of static ratios: *Current Ratio, Quick Ratio, Debt-to-Equity Ratio* and *Debt-to-Total Assets Ratio.*

The Current Ratio is a liquidity ratio that measures the company's ability to repay short-term obligations (current liabilities).

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

The higher the current ratio, the better capable the business is to pay its short-term obligations. A ratio under 1 means the business will have a tough time paying off its short-term obligations. Any business with a current ratio under 1 is in a difficult financial situation and isn't managing the business very well.

Costco has a current ratio of 1.20. Although the current ratio isn't as high as we would like, it shows that the business should be able to pay its current liabilities with relative ease.

The Quick Ratio is very similar to the current ratio. However, you may have noticed that inventory could be difficult to turn into cash quickly at 100% of its value during stressed periods. That's where the quick ratio comes into play.

The quick ratio is a liquidity ratio that measures the most liquid current assets to all current liabilities. This ratio is also called the "acid-test ratio" because it should only be used during the direst of situations when trying to discern whether a business has the ability to meet short-term obligations. It's calculated by adding cash, marketable investments and accounts receivable and dividing the sum by current liabilities. As you can see, inventories aren't included.

$$\textbf{Quick Ratio} = \frac{\textbf{(Cash + Marketable Securities + Accounts Receivable)}}{\textbf{Current Liabilities}}$$

Costco has a 'less-than ideal" quick ratio of 0.55. However, Costco does a great job creating large amounts of cash flow on a yearly basis, and they have constantly been around this 0.55 quick ratio for the last 10 years while growing the business significantly. Add that to the fact that they have ample cash on their balance sheet to cover any short falls. So this isn't something we will worry about too much in such a high quality business.

The quick ratio is the more conservative view of a business's ability to meet short-term obligations. But it's also the most extreme. So it's not always needed, especially for higher quality businesses.

The *Debt / Equity Ratio* is a measure of the business's financial leverage. It represents the proportion of equity and debt the business uses to finance its assets.

$$\textbf{Debt - Equity Ratio} = \frac{\textbf{Total Liabilities}}{\textbf{Shareholders' Equity}}$$

In general, the lower the debt/equity ratio, the less leveraged the business. High debt/equity ratios can result in additional interest expense and volatile earnings compared to similar businesses.

Costco has a debt/equity ratio of 0.41. And the debt/equity ratio has ranged from 0.08 to 0.41 over the last 10 years. This shows how incredibly debt averse Costco really is.

The Debt / Total Assets Ratio measures the total amount of debt compared to assets. Similar to the debt/equity ratio, the higher ratio, the higher amount of leverage.

$$\text{Total Debt To Total Assets} = \frac{\text{Short Term Debt} + \text{Long Term Debt}}{\text{Total Assets}}$$

Costco has a debt / total assets ratio of 0.64. This shows the investor that this business is using leverage conservatively.

Of course, the caveat to using these ratios is they only give you a summary of the business at that point in time. In most cases, the assets and liabilities aren't exactly the real figures stated on the balance sheet. Sometimes it takes added investigation to ascertain the real assets and liabilities. We discuss this further in the coming sections.

Still, these ratios do serve as a great place to start.

Where to Find:
Company filings -- 10K
Search under Long-Term Debt or Debt

Does The Business Have Worrisome Off-Balance Sheet Liabilities?

As we briefly discussed in the previous section, the total liabilities on the balance sheet aren't always the "real" total liabilities.

Let me explain.

In order for an investor to calculate the actual total liabilities of the business, an investor would need to calculate off-balance sheet liabilities too. Off-balance sheet liabilities are contractual obligations that are not included on the balance sheet of the business.

Off-balance sheet liabilities include:

- Unfunded Pension Liabilities
- Lease Obligations
- Warranties
- Purchase Contracts

- Partnerships
- Other contractual obligations not list listed on the balance sheet

Don’t worry. These are easier to find and calculate than you think.

Companies such as Enron and WorldCom have almost become synonymous with egregious misrepresentation of off-balance sheet liabilities.

Operating leases are popular off-balance sheet liabilities that have been used over the years. It’s important to note that accounting rules are tightening to subdue these off-balance sheet liabilities.

Essentially, an operating lease allows a business to record only the rental expense of the building or equipment lease (rental). This is significantly lower than booking the entire lease on balance sheet. Thereby giving the business a cleaner looking balance sheet.

Partnerships are another off-balance sheet liability that must be watched closely like a hawk. When a business has a controlling interest in another business or engages in a partnership, it doesn’t have to show the partnership’s liabilities on its own balance sheet.

As you can imagine, this accounting technique allows for some shady types of activity.

Sometimes, hidden values can be found within these partnerships as well. For example, Ali Baba (BABA) proved to be a significant boost to Yahoo stock before and after its IPO. The hidden value in its Ali Baba stake helped to increase the margin of safety of Yahoo’s (YHOO) stock significantly.

In 2012, during the stagnation of Carol Bartz’s time as CEO, our calculations indicated that the Ali Baba stake represented virtually the entire market value of Yahoo when it was trading at $15/share (net cash). Many of the pros on Wall Street had difficulty seeing the value in this hidden asset. This was mainly due to their preconceived negative biases towards Yahoo. I discuss this more in depth later.

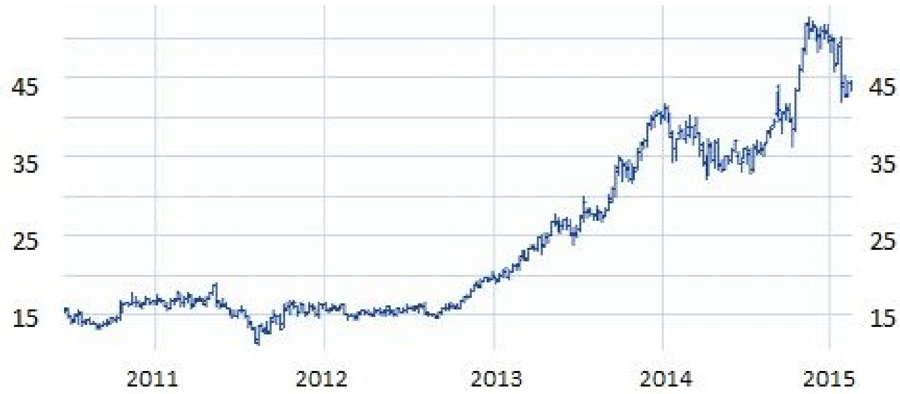


FIG: 30 Yahoo (YHOO), 2011-2015

Great opportunities like this don't come along very often, but it does happen from time to time. That's why it pays to be prepared, and aware of these situations. This particular instance provided opportunity for the prepared and diligent investor.

However, you will sometimes run into businesses that use the partnerships to offload substantial liabilities. Thus resulting in a better looking balance sheet. For example, Enron is a perfect example of this folly. Enron continued to pile up unwanted liabilities into partnerships while no one was the wiser. This ultimately led to their demise and filing of bankruptcy.

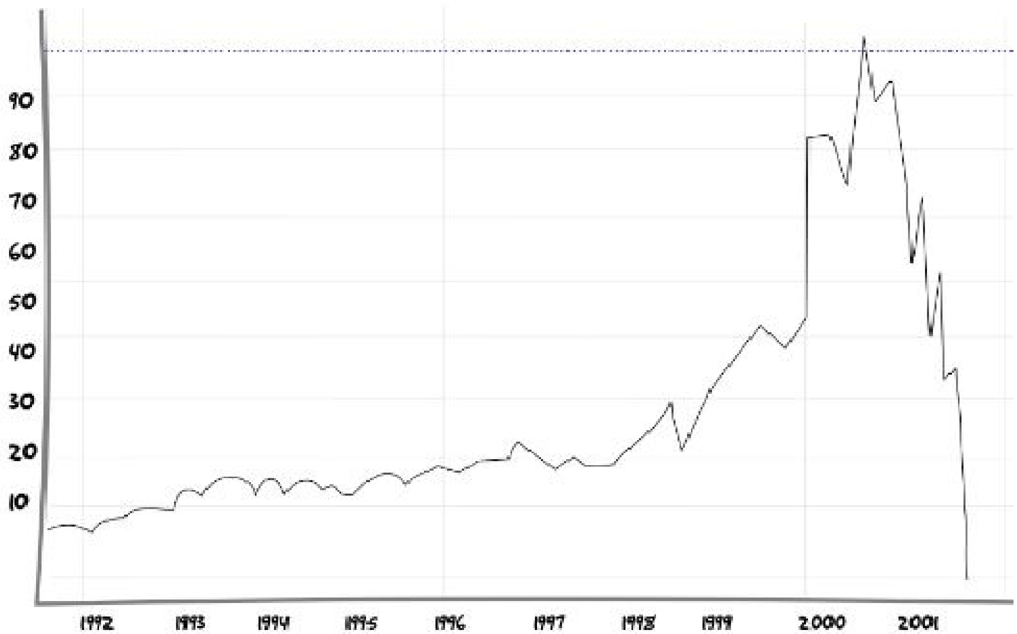


FIG: 31 Enron, 1992-2001

As a general rule, be cautious of businesses and management teams that have excessive off-balance sheet liabilities.

Off-balance sheet liabilities are a discretionary action by the management team. So, a management team that wants to “dress-up” its balance sheet could do so easily if they wanted too. It should make an investor wonder what else they’re trying to hide.

Great management teams are open and transparent. There’s no need for them to play accounting games and gimmicks with their investors.

When analyzing business ratios, an investor should include a conservative estimate of any off-balance sheet liabilities into the total liabilities portion of the ratio. The more off-balance sheet liabilities, the more difficult it can be to properly analyze the business.

Where to Find:

10K Footnotes

Search Commitment and Contingencies

Search Partnerships, Rental or Lease Expenses

Are Capital Expenditures (Capex) Reasonable?

Capital expenditures (Capex) are funds used by a business to upgrade or acquire physical assets such as equipment, buildings or property.

Capex is broken into two forms:

1. *Maintenance C*apex are expenditures to help extend or sustain the useful life of existing assets (maintain).
2. *Growth C*apex are expenditures for the purchase of new assets in an effort to grow the business (growth).

It's easy to blur these two very distinct definitions of Capex. The focus of this book will revolve around maintenance Capex. We will go into detail more on this topic shortly.

As an investor, we care mightily about how earnings flow through to us when all is said and done. Determining the Capex of the business will help an investor calculate the free-cash flow (FCF) which ultimately flows through to the investor at the end of the day.

A business with high Capex requirements means that cash flow must regularly be reinvested to maintain existing assets and operations. This ultimately leads to lower cash flows versus a low Capex business (all else being equal).

For example, oil and gas producers (O&G) often lose money due to the cyclical nature of the business. Generally, it can be quite difficult to invest in this space because if an O&G business starts to generate out-sized cash flow, it must spend the cash flow upgrading drills and allocating funds to find new reserves.

Barring many of the major integrated O&G businesses, investors rarely get to see the cash flow through to them because the cash flows are constantly reprocessed back into the business. This can have a direct impact on the valuation of the business on a non-GAAP basis.

On the opposite side of the spectrum, low Capex businesses carry considerably lower risk compared to a high Capex business (all else being equal). A business with low Capex requirements can reinvest that cash flow to create more value for shareholders in the form of growth initiatives, dividends and share buybacks.

LOW CAPEX INDUSTRIES	HIGH CAPEX INDUSTRIES
Software	Oil & Gas
Franchisors	Railroads
Publishers	Manufacturing
	Distribution
	Cement
	Materials
	Steel
	Retail
	Telecom
	Mining
	Pulp and Paper
	Chemicals
	Theme Parks
	Semicondustors
	Airlines
	Utilities

FIG: 32 Capex Industries Low/High

As you can see, there are significantly more high Capex industries and businesses compared to Low Capex. The ratio of Capex to sales of most the high Capex industries accounts for 20% or more of the industry's revenue (some more than others).

It's important to note, inflation may impair the ability of a business with large Capex to buy new or replace existing assets. Conversely, a business with low Capex can do very well in an inflationary environment.

So how does an Investor Calculate Maintenance Capex?

Capex can be found in the business's cash flow statement, and there is usually additional breakdown in the MD&A section. However, most businesses don't differentiate between maintenance and growth Capex in their financial reports. As a result, an investor will usually have to do a bit of investigation to find the maintenance Capex of the business.

The reason for this necessary exercise is to ascertain the bare minimum it takes for a business to maintain current operations and cash flow. This will give us a normalized Capex number to help value the business conservatively during growth phases or when things go into crisis mode and businesses pull back Capex.

In the calculation of free cash flow (FCF), we want to use use maintenance Capex. But, as we stated before, businesses rarely disclose the maintenance and growth Capex seperately. This can make the ascertaining of maintenance Capex a difficult task.

There is no hard-and-fast formula or process for calculating maintenance Capex. An investor would do well to use one or a combination of the following two methods:

1)Maintenance Capex = Depreciation?

This is the most simplistic method of calculating maintenance Capex. <u>Depreciation should track closely to maintenance Capex.</u>

Thus, if you subtract depreciation from the total Capex number, you could theoretically arrive at a rough estimate of growth Capex.

If a business is in a low or consistent growth pattern, it is easier to use depreciation for the calculation of maintenance Capex. Otherwise an investor will need to adjust the depreciation up or down depending on maintenance of the business's assets.

An investor needs to ascertain how long the assets will last till they need to be replaced. Focus on the assets that need to be maintained (machinery, office buildings) and ex out assets that don't (like land). As a general rule, maintenance Capex will increase as assets get older.

Here is a trick to calculate the rough estimate of the average age of the assets:

Average Age of Assets = (PP&E - Accumulated Depreciation) / PP&E

An investor will need to adjust to straight-line depreciation if the business is using an accelerated depreciation schedule.

For example, the ratio of net assets to gross assets at Exxon (XOM) was 56%, which means that the assets are getting very close to their half-life.

This would alert investors to the possibility of Exxon seeing higher maintenance Capex to improve drills and other machinery in the near future. In this instance, you would make downward adjustments to future cash flows in anticipation of an increase in future maintenance Capex.

Typically, the closer the ratio of net assets to gross assets is to zero, the higher the probability that a business will face higher maintenance Capex to acquire new assets to replace the old in the near future.

Of course you are trusting that management correctly states the schedule of depreciation. And we know how easy it is to manipulate this number.

There are a number of different schedules management can use to state depreciation (straight-line, accelerated, etc). They could even hold back depreciation for a number of quarters in an attempt to boost GAAP earnings. Or management could just be too confident about the sustainability of their assets.

BOTTOM LINE: Depreciation can be very misleading at times, and can be easily manipulated.

That's why the next method is a better approach in the calculation of maintenance Capex.

2)The Greenwald Approach (EPV)

Columbia University Professor Bruce Greenwald explained in his book, *Value Investing: From Graham To Buffett And Beyond*, a simple method for calculating the maintenance Capex for businesses:

- Calculate the Avg Gross Property, Plant, and Equipment (PP&E)/sales ratio over 7 years
- Calculate current year's increase in sales
- Multiply PPE/Sales ratio by increase in sales to arrive to growth Capex
- Maintenance capital expenditure is the Capex figure from the cash flow

statement less growth Capex calculated above, which is the true depreciation for the company

Overall, this is the best method and it makes perfect sense for reliable businesses. However, it won't work very well for high Capex businesses. If the Capex number is less than the sales growth number, the calculation seems to have issues.

These two methods aren't perfect, but the Greenwald approach, rationally and practically, seems to calculate maintenance Capex more accurately for most businesses.

REMEMBER: Don't beat yourself up over the math.

If you feel stuck, or are having difficulty calculating the maintenance Capex, just try to use a conservative estimate of depreciation as the rough appraisal for maintenance Capex. You may need to normalize CFO as well to arrive at a reasonable FCF figure.

Maintenance Capex = Depreciation
So…
Free Cash Flow = Net Cash from Operations – D&A

Growth vs. Maintenance Capex

So this brings us back to why it's so important to separate Growth and Maintenance Capex.

We have determined already that maintenance Capex is a cost, while growth Capex is more of an investment. Growth Capex is normally related directly to the increased FCF a business is producing. Thus, an investor must make sure that capital is being reinvested at a reasonable rate of return to rationalize the growth Capex figures.

Many businesses do not separate out the maintenance and growth Capex. This can make it difficult to calculate with any degree of certainty. However, there are usually clues that we can use to ascertain conservative estimates.

For example, Costco (COST) stated in their latest annual report (10K) that they opened 30 new warehouses in 2014 with a total Capex of $1,993M, and were anticipating an additional 35 new warehouses in 2015 with Capex expected to come it between $2,500M - $2,700M.

These big increases in Capex are a perfect example of growth Capex. However, we were not privy to the exact growth Capex figure (just total Capex). It is clear that we need to separate the maintenance Capex from the growth

Capex to arrive at the true profitability of the business.

Imagine that Costco cut all growth projects. And stopped building new warehouses tomorrow -- cold turkey.

What would the result be to the financials?

The likely result would be massive and quick reduction in Capex. This would have an almost immediate increase in FCF. Essentially, the business cut growth initiatives for short-term generation of FCF.

This was obviously an extreme example, however this is a decision that every business will face at one point or another. This could be a result of an broad market economic slowdown or the business maturing.

An investor would be well prepared to know how to calculate the growth Capex figures in relation to total Capex.

In regard to Costco, I believe that either the depreciation or Greenwald method provides a reasonable figure for the maintenance Capex.

All we need to do at this point is find the adjusted FCF number with only the maintenance Capex. But first, let's look at the calculation of FCF without separating the growth Capex. See figure below (fig. 33).

Regular Free Cash Flow

	2012	2013	2014
Cash From Operations (CFO)	3,057	3,437	3,984
Growth and Maintenance Capex	1,480	2,083	1,993
Regular Free Cash Flow	1,577	1,354	1,991

3 Year Avg of Regular FCF =	$ 1.64 B
P/Market Cap =	37.52
P/EV =	36.11
Market Cap =	61.55 B
Enterprise Value =	59.24 B

FIG: 33 Costco Regular Free Cash Flow Calculation

Now see the adjusted FCF numbers (without growth Capex), and how it impacts the valuation characteristics of the business (fig. 34).

Adjusted Free Cash Flow

	2012	2013	2014
Cash From Operations (CFO)	$ 3,057.00	$ 3,437.00	$ 3,984.00
Depreciation and Amortization (maintenance Capex)	$ 908.00	$ 946.00	$ 1,029.00
Adjusted Free Cash Flow	$2,149.00	$2,491.00	$2,955.00

3 Year Avg of Adjusted FCF = $ 2.53 B

P/Market Cap =	**24.31**
P/EV =	**23.40**
Market Cap =	61.55 B
Enterprise Value =	59.24 B

FIG: 34 Costco Adjusted Free Cash Flow Calculation

As you can see by this calculation, it shows the true earnings power of a business when it just operates its main business without any growth initiatives.

The business has averaged just over $2.5 billion per year in FCF in the past three years. That gives them a price to market cap multiple of 24.31, and a price to enterprise value multiple of 23.40. It's a little expensive for my taste, however I think it shows how wide the discrepancy can be in valuations if you don't separate growth and maintenance Capex.

An investor's understanding of maintenance and growth Capex is crucial. Not only is Capex a very important figure in the operation and growth of the business, it's an essential component of an investor's conservative calculation of intrinsic value using discounted cash flows (DCF).

We will discuss this more in the margin of safety section, so stay tuned.

Where to Find:

10K and 10Qs

Cash Flow Statement

MD&A section
Search for "property, plant and equipment"
Search for "cash flow from investing activities"

Will The Business Be Able To Withstand a Short-Term Disaster?

Cash is the lifeblood of any business. There are 2 main avenues in which cash can provide flexibility and liquidity:

1. Cash on the balance sheet
2. Steady stream of cash flow from operations (CFO)

We all know that cash flow is great. It's a requisite for any investor in the sustainability of the business. However, if a disaster struck tomorrow, how well would the business react to the situation?

If a hurricane hit in the Gulf of Mexico, would that insurance company be able to withstand the expected insurance claims?

If a terrorist attack occurred and shut down a business for 60 days, would they be able to make it out unscathed?

If the U.S. slipped into a multi-year recession (or depression), would the business have adequate liquidity on its balance sheet to weather the storm?

Understanding the liquidity of the balance sheet helps an investor determine the amount of time it would take for the business to pay its short-term liabilities (current liabilities). The ratios we discussed earlier are great for the bigger picture of the balance sheet. However, "really" understanding the current assets on the balance sheet can mean the difference between survival and insolvency in many cases.

We will touch upon this more in the liquidation valuation section in the Margin of Safety chapter, however this will be a great introduction to the specifics of the balance sheet and how we determine how quickly current assets can be liquidated on the balance sheet. The balance sheet is already organized in order of liquidity with the current assets on top and the long-term assets below.

Current assets include cash, accounts receivable and inventories. Long-term assets include property, plant and equipment.

Cash

Contrary to popular belief, cash is not always as liquid as you think.

Business is global. Many businesess produce sales overseas in foreign countries, and keep that cash in the country that earned the sales. They do this in order to avoid good ‘ole Uncle Sam (aka the “tax man”).

Many businesses have locked themselves in a corner because they wanted to put the cash to work during the period of growth in the U.S. from 2009-2015. However, if they repatriated the cash to invest in the U.S. it would be taxed.

For example, in 2014, Apple (AAPL) had over $100 billion in cash overseas. Apple would have to pay taxes of up to 35% if it wanted to use the cash for investments in the U.S. or even for stock buybacks. That’s why much of the cash on businesses conducting business internationally, should be discounted for the taxes it would have to pay.

Of course, Congress seems to be setting up tax holidays to allow these businesses to repatriate the cash back to the U.S. at a rate below 10%. So this could all be a moot point, but it’s important to recognize nonetheless.

U.S. businesses are also taking advantage of a loophole called tax inversion, which allows them to purchase foreign corporations, and then domicile the U.S. based business in the foreign country. The foreign country usually has lower corporate tax rates, which provides an immediate ROI to the U.S. based business.

Whether those gains will prove to be sustainable over time, is a topic for another day. Corporate tax inversion seems to be the “craze” with upper management and activist investors in the U.S. right now. However, I’m not too concerned with it.

Long-term, I do believe it’s bad business practice by the leadership of the U.S. based corporations. However, I also understand why they feel they need to make those types of decisions.

Like I said before, business is global. The U.S. is “flat out” getting beat by better competition right now. The U.S. has one of the highest corporate tax rates in the word, and as a result it is leaving opportunities for other countries to attract big business. I guess it’s just the cost of doing business in a country with excellent rule of law.

Either way, capitalism is a complex adaptive system, and it’s my belief that the US will conform and adapt again to become competitive with the rest of the world. Tax inversion just seems like a great deal of work to sneak around and save a buck or two. There are easier ways…

BOTTOM LINE: Additional discounts to the cash on the balance sheet may be needed if the cash is being used for upcoming contractual obligations such as the purchase of inventory or property.

Accounts Receivable

Accounts receivable is considerably important for businesses that sell goods and services on credit. In order to understand how quickly a business will be able to collect its accounts receivables, you will need to calculate receivables turnover.

$$\text{Accounts Receivable Turnover Ratio} = \frac{\text{Net Credit Sales}}{\text{Average Accounts Receivable}}$$

This calculation provides the time required to convert receivables into cash. The higher the receivables ratio, the more advantageous it is for the business. This means the business is collecting payments more often throughout the year.

Who doesn’t want to get paid more frequently, right?

For example, a ratio of 4 tells us that the business collects receivables 4 times a year. In other words, it is collected every 3 months. Businesses that are able to achieve higher turnover ratios than others in their industry, have a distinct advantage over their competition from a cash flow standpoint. The faster a business collects payments from customers, the quicker it will be able to pay for its obligations.

By dividing 365 days by the turnover ratio of 4, you are able calculate the number of days it takes for account receivables to turn into cash.

DSO ratio = accounts receivable / average sales per day, or
DSO ratio = accounts receivable / (annual sales / 365 days)

This is called the days sales outstanding (DSO). The lower the number, the better. This can be extremely helpful for an investor trying to determine whether the business might face short-term liquidity issues.

In our current example above, it takes 91.25 days for a business to turn receivables into cash. At the same time, if the business had short-term debt coming due in 45 days, it could be a major problem and could lead to short-term liquidity complications.

Essentially the business has no money to pay for the bills that are coming due.

You can use the days sales outstanding to determine if a business is able to meet short-term debt issues and avoid potential liquidity problems with the business.

Inventory

Inventory turnover can give an investor an understanding of how long it takes for inventory to be turned into cash. This is calculated by dividing the COGS by average inventory.

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Then we want to ascertain the number of days it takes to sell the inventory. We get that number by dividing 365 days by the Inventory Turnover Ratio.

$$\text{Average days to sell the inventory} = \frac{\text{365 days}}{\text{Inventory Turnover Ratio}}$$

Inventory turnover is one of the main ways a business produces revenue. This makes it a very important asset, and one we must know very well (especially when investing in deep value investments).

REMEMBER: If a business is unable to purchase inventory or doesn't have enough inventory on hand it will lose potential sales. Conversely, too much inventory for extended periods of time isn't good either. There is a balancing act that must occur with inventory levels. So, we want to make sure management is doing a good job with inventory turnover.

Failing to off-load inventory can lead to extra costs such as the product becoming obsolete (electronics), the product decreasing in price (oil and gas) and even having to pay to store the inventory.

Check The Long-Term Liquidity Of The Business

It's much easier to make a reasonable prognosis of short-term liquidity (compared to the long-term). Using the current ratio and the quick ratio will help immensely in your determination of the short-term liquidity needs of the business.

However, over the long run there are variables that even debt-equity ratios could never predict.

An investor would need to understand a business (and its industry) intimately in order to reasonably predict the financial strength of highly cyclical businesses at their peaks and troughs. Ratios and other methods used to evaluate the long-term liquidity of a business are less precise.

Therefore, specialized knowledge of the business or its industry is ideal. However, there are ways to make reasonable projections to long-term liquidity, even when you don't necessarily have that specialized knowledge.

A business that uses forms of permanent capital instead of short-term financing to run its business, is likely to have better long-term liquidity than most.

For example, Pershing Square (AMS:PSH) raised up to $2.7 billion in permanent capital with its IPO on the Euornext Amsterdam exchange. For those not familiar with Pershing Square, is the hedge fund of Mr. Bill Ackman. Personally, I have a tremendous amount of respect and admiration for what he does and how he conducts himself.

Permanent capital is the dream of any business or investor. So I know he was chomping at the bit for this opportunity.

This is capital that has no margin calls, doesn't come due and doesn't trade for less due to extraneous or exogenous events outside its control. The ability to add permanent equity to a capital base strengthens a balance sheet immensely. It can provide safety and the option to take advantage of opportunities that present themselves.

In 2009, Ackman did impeccable work with his investment in mall owner General Growth Properties (GGP) as it was teetering on the edge of bankruptcy. Ackman had already invested a significant portion of capital into GGP, and he wanted to allocate more.

There was a problem though…

His investors were spooked by the recent financial and economic crisis and started asking for their money back. As a result, Bill had to keep more than 50% of his fund in cash to smooth out redemption requests. He wanted to put more money to work in his best idea with GGP, however he was hand-cuffed.

Fast forward to present day, and GGP is trading at 150 times the market value it was trading at in 2009. Ackman still regrets not being able to allocate more to his investment in GGP.

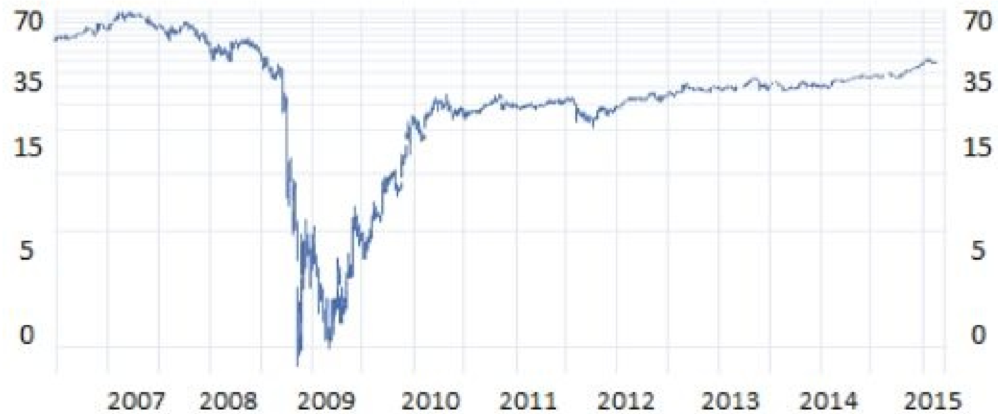


FIG: 35 General Growth Properties (GGP), 2007-2015

Full Disclosure: Held positions in GGP from 2009-2011. No longer hold positions.

“I had one hand tied behind my back,” Mr. Ackman says. “In 2009, we wanted to go on the offensive. But even though we were up a lot that year I still felt like we missed out. Because of the possibility of massive redemptions we had to hold too much cash.”

Now with access to this permanent capital, Ackman won’t have to feel held back when an opportunity presents itself.

This particular investment vehicle offers investors the ability to “ride along” with a great capital allocator in Bill Ackman which has produced returns over 20% per annum since inception. And it also offers investors better rates on management fees compared to that of his actual hedge fund (I wonder how his hedge fund investors felt about that).

Permanent capital can come from various sources such as management making opportunistic stock sales when stock prices are elevated (equity raise) or converting debt to common shares. The most favorable alternative to permanent capital would be long-term debt at very favorable rates (Costco).

Here are some quick checks to help you determine whether a business has potential liquidity issues on the horizon:

Is The Debt Recourse or Non-Recourse?

There only only two types of debt: recourse and nonrecourse.

An investor is interested in non-recourse debt because this is debt that is secured by collateral and assets. It allows the lender to pursue only that collateral. It doesn’t put the rest of the business in danger (barring certain other exigencies).

This can be very important because instead of an outright default with potential legal and liability proceedings in the future, a business could simply exchange the asset or collateral to the lender in exchange for forgiveness of the loan.

As long as the asset is deemed to be a non-core asset to business operations, then the business may be able to escape potential liquidity issues.

What are the Loan Covenants?

Loan covenants are the terms of the loan. The lender typically sets the terms, and they are put in place by lenders to protect themselves from the borrowing business defaulting. If a business drops below certain ratios or thresholds set forth in the covenants, the lender usually has the right to call back the debt from the borrower.

This is a very rare event. Unless the business is destined for obsolescence or rattled in debt, the lender and borrower typically adjust the covenants or refinance the obligations.

Examples of loan covenants include:

- Current Ratio > 1.2
- Coverage Ratio > 3
- Maximum dividend payments
- Certain amount of working capital

Understanding the loan covenants set by lenders can be crucial to a business being economically stressed now or in the future. It can be a sign that a business is becoming financially stressed if it nears certain limits or fails to meet the stipulations of the covenants.

Where to Find:

10K and other financial filings

Search: “loan covenants” / “loan”

What’s The Debt-Maturity Schedule?

Investors need to know when certain debts and obligations will be coming due to adequately assess the liquidity risk of the business. The ability to default or the inability to refinance is a major risk to a business.

Search for the debt schedule and ascertain when the dates are due. These are the types of questions you should ask:

Are there big obligations coming due soon or in the next 2-5 years that will put the business at risk?

Will they be able to refinance it, instead of paying it off (dependent on the business’s financial health)?

Are the credit markets functioning properly to allow for financing (circa 2008/2009)?

Where to Find:

10K and other financial filings

Search: “maturities” / “debt schedule” / “short-term debt” / “long-term debt”

Are Interest Rates On The Debt Fixed or Variable?

Variable rates can wreak havoc on a business.

Investors should determine if the obligations are fixed or variable because variable rates add an element of uncertainty during periods of increasing interest rates.

Fixed rates give us a better ability to plan for liquidity issues.

For example, Costco carries over 90% of its long-term debt at very favorable fixed rates ranging from 0.65%-5.5%.

Where to Find:

10K and other financial filings

Search Footnote titled : “Debt” / also search “loans”

So…

Does your investment have a “Fortress” Balance Sheet?

Step 5 of MECOM™: **Management --** Can you trust them?

In 1960, a business was built from scratch by a man raised on a small ranch near Haslet, Texas (northwest of Fort Worth). He would go on to grow this business through multiple recessions into a global powerhouse.

Over almost three decades, he returned an outstanding 20.4% compounded annual return to shareholders (S&P returned 8%)!!! During his tenure, he skillfully repurchased 90% of the company's shares outstanding. There is little doubt; he will go down in history as one of the greatest managers and capital allocators of all-time.

Have you guessed who this person is yet?

And no --- it's not Warren Buffett.

His name is Henry Singleton, and the company he built was Teledyne, Inc (TDY).

"Henry Singleton of Teledyne has the best operating and capital deployment record in American business."
Warren Buffett

Singleton's broad strategy was two-fold:

1) He would make acquisitions using company stock when its price was high.
2) He would buyback shares repeatedly when the share price was low.

Of course, this was contingent on his ability to properly choose the right businesses and operate them efficiently.

So many individuals (professionals and amateurs alike) try to make something that's inherently simple into a complex matter. I used to do it all the time. And I still do till this day.

The human brain wants to make shortcuts, however, it also has a difficult time believing certain things can be done simply. It looks for complexity. As humans we sometimes think it has to be complex in order to understand.

We make it so hard on ourselves sometimes by making simple situations incredibly complex. We will say things like, “It can’t be that easy, right?

Yes It Can.

There is no shortcut to success in anything. Talent is given to some people, but skill is acquired through work ethic. This doesn’t mean that you can’t use simple models and concepts in acquiring and executing on that skill though.

“If one took the top 100 business school graduates and made a composite of their triumphs, their record would not be as good as that of Singleton, who incidentally was trained as a scientist, not an MBA. The failure of business schools to study men like Singleton is a crime. Instead, they insist on holding up as models executives
cut from a McKinsey & Company cookie cutter."

Warren Buffett

Singleton was an incredibly savvy manager and operator. When his stock was pricey (40+ times earnings), he would essentially use it as a currency to acquire generally sound businesses selling at low earnings multiples. When his stock was selling at low multiples to earnings, he would aggressively buyback stock.

Nothing in the world is certain. However, by using this simple strategy, it seems highly probable that good things will happen over the long haul. When it was all said and done, he reduced the share count more than 90%. He repurchased stock in the $6 per share range in the early 70s. The stock traded at more than $400 per share by the late 80s.

<u>It proves how a business can grow by getting smaller.</u>

"American business is still gripped with a mania for bigness. Companies whose stocks sell for five times earnings will think nothing of going out and paying 10 or 15 times earnings for a nice big acquisition when they could tender for their own stock at half the price. Shrinking -- à la Teledyne -- still isn't done except by a handful of shrewd entrepreneurial companies."

Henry Singleton

The topic of management begs the question then, “Do you bet on the horse or the jockey?”

As we discussed previously, you always want to look for great businesses first and foremost.

“Good jockeys will do well on good horses but not

on broken-down nags."
Warren Buffett

However, we must never forget that management is responsible for the direction of the business. Essentially we are partnering with the management of the business to invest our money. Management could make or break your investment.

It only makes sense to seek out and focus on quality management teams which can be stewards of your capital.

Truth be told, most investors overlook the human element of operating a business. In a world of algorithms and quantitative screens it's easy for an investor to ignore the qualitative aspects of management quality. However, it's those intangible management qualities that can usually be the reason for future success or failure of the business. Ignore the quality of management at your own risk.

Remember, capitalism is a brutal arena. I don't know about you, but I want the best of the best in my corner. Even if you find competitive advantages in a business, those competitive advantages will be attacked. The advantages will be cloned over time.

If you don't have talented management in place to continually innovate and create value for ALL stakeholders, a seemingly risk-averse investment may not look great anymore if management deteriorates your supposed margin of safety.

As the investor, management works for you. Never forget that.

As a person looking in from the outside, it's impossible to know every single thing that's going on inside the business. The variety of variables and decisions that are made on a daily basis ensures that you will never know everything about the business. And that's ok. That's why we focus on only the most important factors for investment success in this book. Everything else is just noise

"It's not given to human beings to have such talent that they can just know everything about everything all the time."
Charlie Munger

The trust of management is vital for your investment and emotional stability. There are 5 main questions you need to answer to help you pinpoint quality and trustworthy managers:

1. What is management's track record?

2. Does management have an ownership stake in the business?
3. Is management incentivized properly?
4. Is management keeping costs under control?
5. Is there a great culture within the business?

We will go into each of these in detail.

Where to Find:
LexisNexis
Dow Jones Factiva
Wall Street Journal
New York Times
Financial Times
Other Trade journals
Interview services: 60 minutes, Charlie Rose Show, Wall Street Transcript.

10Ks

What is Management's Track Record?

"I have no use whatsoever for projections or forecasts. They create an illusion of apparent precision. The more meticulous they are, the more concerned you should be. We never look at projections, but we care very much about, and look very deeply at, track records. If a company has a lousy track record, but a very bright future, we will miss the opportunity..."
Warren Buffett

Jon Corzine made partner at Goldman Sachs in the 1980s as a government bond trader. He was known in many prominent circles as a brilliant man, and quickly made his way up the ranks managing the entire bond trading operation at Goldman.

An unexpected rise in interest rates in 1994 put many fixed income departments on the verge of collapse. Because of surmounting losses, this one division at Goldman was a direct threat to its very survival. Goldman Sachs survived, and instead of letting Corzine ride off into the sunset, the partnership felt it had to give him a raise to Chief Executive!?!?

No one else knew those positions to the extent that Corzine did. He was the best person to unwind all the excess risk that he put in place from the very beginning. Goldman could not lose him because of their exposure to the rising interest rates.

If you owe the bank $100,000, they own you. If you owe the bank $100 million, you own them, right…?

This financial aphorism rings true again.

Fast forward through under-dealings at Goldman, a coup of leadership at Goldman, and unremarkable stints as Senator and Governor of New Jersey, Corzine landed the "head honcho" position at MF Global (medium-sized brokerage firm).

After his appointment to CEO in 2010, it didn't take long for his excessive risk-taking to take hold. Ultimately, his bets on European sovereign bonds pushed the firm into chapter 11 bankruptcy.

**It's important to note that these bets were correct over the long term.*

However, leverage doesn’t give you the ability to be patient. Impatience and excessive risk taking (with leverage) aren’t qualities an investor looks for in top-tier managers.

Up to $1.6 Billion in customer funds were also “misplaced” in the final days of MF Global.

How’s that for an interesting corporate ladder ride?

His triumph of failing forward eventually led to him being charged by the Commodity Future Trading Commission (CFTC) in connection with MF’s bankruptcy.

Now, knowing his history, would you have invested in MF Global with this type of manager at the helm?

That’s why we go through some basic research on the management of the business.

BOTTOM LINE: The smartest person in the world doesn't mean a great deal to an investor if he/she isn't able to convert that intelligence into returns. It is essential that you ascertain the track record of management to determine whether they will be able to continue in the success of the business.

In Corzine’s case, there were red flags that very basic research would’ve revealed.

Here are some areas you want to focus on to determine whether management's track record is acceptable for investment:

How did the manager get to the position?

In order for an investor to understand a management team and its background, construct a time line of the CEO. We typically like to look at the top 5 managers and the board of directors too. That is completely up to you. However, its imperative that you have an understanding of the CEO’s history.

You want to be able to map out the professional life so you can easily see successes and/or failures over time. You want to go as far back as possible. Bios on the company’s website may not be enough. You may have to work a little harder to find information. This shouldn’t be too difficult given the age of technology and information we live in today.

For example, I used a combination of articles, historical proxy statement and Wikipedia to compile the career of Jon Corzine, shown below:

<u>1975</u> - *Begins working for Goldman Sachs as a bond trader.*
<u>1980</u> - *Is named a partner at Goldman Sachs.*
<u>1994</u> – *Makes risky bets threatening Goldmans Sachs survival.*
<u>1994-1999</u> - *Chairman and chief executive of Goldman Sachs.*

<u>1998</u> – Attempts to purchase distressed LTCM from under the Fed and the rest of Wall Street.
<u>1999</u> – Loses a power struggle at CEO with Hank Paulson leaves Goldman.
<u>1999</u> – Still makes ~$400 million on Goldman IPO.
November 7, 2000 - Is elected to the United States Senate.
<u>2001-2006</u> - United States Senator representing New Jersey.
<u>November 8, 2005</u> - Is elected governor of New Jersey.
<u>January 17, 2006-January 19, 2010</u> - 54th Governor of New Jersey.
<u>July 1, 2006</u> - Orders a government shutdown amid a budgetary impasse between the state legislature and his office. It ends on July 8th.
<u>November 3, 2009</u> - Is defeated in his re-election bid by Republican Chris Christie.
<u>March 23, 2010</u> - Is named CEO of MF Global.
<u>October 31, 2011</u> - MF Global files for bankruptcy after it is revealed that more than $600 million of customer money is missing.
<u>November 4, 2011</u> - Corzine resigns from MF Global.
<u>December 2011</u> - Corzine testifies multiple times to various government Committees, claiming he does not know where the missing customer money went.
<u>November 15, 2012</u> - The House Financial Services Subcommittee on Oversight and Investigations releases a report saying that Corzine's risky decisions led to the loss of customer funds.
<u>April 4, 2013</u> - Louis Freeh, bankruptcy trustee for MF Global and former head of the FBI, releases a report blaming the demise of the commodities trading firm on Corzine.
<u>April 23, 2013</u> - Louis Freeh files a lawsuit against Corzine and two lieutenants at MF Global saying their risky decisions led to the company's bankruptcy and the improper use of the client's money to cover losses.
<u>November 5, 2013</u> - A bankruptcy judge approves a recovery plan that will allow almost 26,000 customers to collect 100 cents on the dollar of a combined $1.6 billion in lost investments from MF Global.
<u>March 11, 2014</u> - Corzine's youngest son, Jeffrey Corzine, 31, commits suicide in a Mexico City hotel room.
<u>December 23, 2014</u> - A New York federal court orders MF Global Holdings to pay restitution in the amount of $1.212 billion, plus a $100 million civil penalty for its subsidiary's misuse of funds.

This is a very detailed biography. If we had just used the bio on the company website, we wouldn't really have an understanding of the manager's career and previous track record.

By building this detailed time line of a manager's career, an investor will begin to understand how the manager rose through the ranks, who they worked for and the kinds of jobs they held. For example, Corzine made his way through the ranks from bond trader. Traders are typically short-term oriented and have no problem using leverage. This could've set off some red flags.

These are some questions you want to start asking yourself as you look at the timeline:

1. Is the manager loyal? Did they go from job to job?
2. Are there gaps in the manager's job history? If so, why?
3. What is the manager's background? Marketing/Sales, Finance, Operations?

I typically pay a great deal of attention to the manager's proximity to all stakeholders (customer, employees, suppliers, etc.). For example, a CFO or Treasurer that makes the jump to CEO is likely to not have the background or skill set of dealing with the complexity of operating a business as a whole. The extent of their experience has been number crunching in a corner office. Do they really understand the business and the needs of all stakeholders?

Where to Find:
Historical proxy statements

What is the Manager's experience with the Customer base?

An investor should typically avoid managers that have served customers in a different industry or have spent most of their career displaced from the customer base. This matters a great deal in retail and restaurant type businesses where understanding your customers' buying habits is essential to the success of the business.

Does the Manager have an Operations background?

Investors should be cautious of managers that have risen through the corporate ladder and lack the necessary operations background. Typically, managers that have spent their careers in corporate towers lack the day-to-day operations experience to lead the business into the future.

Usually it's a case of not being able to see the forest through the trees with these types of managers. They have been taught to see things a certain way their entire lives, so they are unable to see or think outside of that box.

"If you only have a hammer, you tend to see every problem as a nail."

Abraham Maslow

If a manager that's been responsible for the accounting of the business suddenly gets promoted to CEO, how can we know if that person can "really" operate the business in the interest of multiple stakeholders? Typically, these types of managers have a very a narrow focus of the business because they view it from a very specialized lens. And there's nothing wrong with that per se. But as the leader of the "entire" business, one must be able to see the bigger picture in order for the business to grow longer term.

Alex Taylor wrote a great book about the decline of GM, *Sixty to Zero: An Inside Look At The Collapse of General Motors - and the Detroit Auto Industry*. He describes how GMs best years were when Harlow Curtice was leading the company. Curtice was an innovator in his field and led GM as CEO from 1953-1958.

Oddly enough, he started his career as a bookkeeper, but he quickly made his way to the sales side of the business. It was during this time that he started to learn how vehicle design created the ability to market and sell the cars. He truly had an understanding of how the business was operated and how it could grow because he knew what buyers were interested in the most.

After Curtice's tenure as CEO, the accountants took control. These managers were more concerned with cutting costs instead of finding the next great vehicle design for consumers. As you can imagine, years of this type of management left GM in shambles and ultimately led to its bankruptcy with a massive capital injection from the U.S. government in 2009.

CFO type managers typically have incredible experience, deep business knowledge, and are great for recommending and executing on mergers and acquisitions. The distinction lies in how the manager is able to grow the business. CFOs typically look inward, whereas the best CEOs focus outside of the business to innovate. This will ultimately lead to more sales and customers if done correctly.

Every situation is different. Sometimes innovators will make the best managers. Other times it may make sense for a more financially-minded CEO to be in charge.

Ideally, an investor wants a CEO with understanding and experience from different portions of the business (i.e. Finance and Sales). Obviously these kinds of managers are few and far between, but it doesn't mean we don't stay on look out for that rare occurrence.

Has the manager produced results before (or been part of the results)?

As an investor you will have to determine whether the manager has been a successful operator of the business. If a manager has previously lost money or driven a company to bankruptcy, that's obviously a major red flag. For example, Corzine's resume should have been reason enough for MF Global's Board of Directors to question his ability to lead the business.

John Malone, Chairman of Liberty Media, is a great capital allocator, and rivals Warren Buffet as one of the best of all time. Although their styles differ somewhat, it cannot be denied that he has created a tremendous amount of shareholder value.

It gets tricky to calculate his returns because he essentially took a "vacation" after he sold his business, TCI, to AT&T in 1998. In the first tracking period of 1973-1998, he produced a CAGR of 30%. In the second tracking period of 2006-2014, he produced a CAGR of over 30% again.

Quite impressive, wouldn't you say?

As the previous example has showcased, it cannot be stated enough just how vital it is to focus on a manager's ability to reinvest excess cash flows at reasonable rates of return. Great capital allocations are few in number. So when you find them, make sure to take note. Keep them (and their top execs) on your radar or watch-list for potential investment in the future. Hold onto them for dear life.

Management needs to decide how it will reinvest or distribute excess cash flow on a consistent basis. There are essentially only five ways a management team can allocate excess cash flow:

1) Do nothing (hold cash on the balance sheet)
2) Buy back stock
3) Pay dividends
4) Make acquisitions
5) Reinvest capital back into the business (new locations, expansion, etc.)

There is an important distinction to be made here too. There is a difference between great operators and great capital allocators.

Typically you will have one or the other in a great manager. In fact, the best capital allocators are usually removed from the day-to-day operations of the business.

This gives them more time and energy to focus on capital allocation instead of the operations. Such managers include John Malone (Chairman of Liberty Global), Warren Buffett (CEO of Berkshire Hathaway), Bruce Flatt (CEO of

Brookfield Asset Management), Peter Carlino (CEO of Penn National), James Tisch (CEO of Loews), Henry Singleton (CEO of Teledyne) and Tom Gaynor (President of Markel).

These managers typically delegate the day-to-day operations to a Chief Operating Officer (COO). This allows them to focus on the bigger picture of growing the business and finding areas of opportunity.

An investor that focuses on historical decisions such as acquisitions and buybacks will have a tremendous understanding of how a manager makes capital allocation decisions. Answering questions such as:

Does the manager make buybacks at high multiples to cash flow or buy opportunistically when they are below intrinsic value?

Does the manager make acquisitions at high multiples to cash flow and book value or buy when they are priced lower for better ROI?

For example, Jim Sinegal (CEO of Costco) is renowned for being very shrewd and savvy when he makes capital allocation decisions. One decision that sticks out is his decision not to enter the rapidly growing Chinese market.

Almost every other big retailer is entering China as quickly as possible. And many of these big retailers are having a very tough time in China right now because they did not understand the Chinese market, and its culture very well. The pull-back in China’s retail spending was a big red flag for Costco. As a result, they took a “wait and see” approach.

Costco’s capital discipline is incredibly conservative. They never want to stretch management too far where they can’t do business the way they choose to run it. Costco’s feeling is that China will always be there. So there’s no rush to jump in if they believe they will be over-extending themselves and their company culture.

How many CEOs would be willing to wait on the sideline while their competitors were entering an emerging growth market?

Not many.

This speaks volumes to the discipline of Costco, and the types of decisions they make on a consistent basis. This is a business you can trust to be stewards of your capital.

As mentioned earlier, there aren't that many John Malone's and Jim Senegal's in the world. They do exist, but they’re certainly few and far between. But therein lies the beauty.

Because there are so few great capital allocators in the world, you can find them quickly and easily. They will stand out by their consistent returns on capital.

Quick Tip: By focusing on managers with proven consistent returns on invested capital (ROIC) and return on equity (ROE) you can pinpoint great capital allocators.

Where to Find:

10-K

Does Management Act As An Owner-Operator?

If management and the board have no meaningful stake in the company – at least 10 to 20% of the stock – throw away the proxy and look elsewhere.”
Martin Sosnoff

"Acting" as an owner operator doesn't mean the manager needs to be the founder/owner.

It means that the manager (owner or not) acts in the best interest of the business as if they owned the entire company. An investor wants managers with “skin in the game” or that have incentives that line up with shareholders.

Typically these managers have the following characteristics:

- Entrepreneurial minded
- Own a large stake in the business
- Buy stock and businesses opportunistically
- Pay dividends when there are no opportunities for investment
- Produce reasonable rates of return on capital
- Take a long-term perspective on the business
- Passionate about the business
- Equate personal success with the survival and growth of the business
- Interests aligned with shareholders

Below I will elaborate on some of the areas you should focus on the most:

Are the managers increasing their ownership stake in the Business?

Investors should always look for managers that maintain or increase their ownership in the business.

I don't know about you, but if I'm giving my money to someone, I want to make sure they have a vested interest in the future success of the business. For example, these managers have kept or increased their stakes during their tenures:

- Henry Singleton, Former CEO of Teledyne
- Warren Buffett, CEO of Berkshire
- Jim Senegal, CEO of Costco
- Dave and Sherry Gold, founder of 99 Cent Only Stores
- Bruce Flatt, CEO of Brookfield Asset Management
- John Mackey, CEO of Whole Foods
- Jeff Bezos, CEO of Amazon
- Carl Icahn, CEO of Icahn Enterprises
- Jeffrey Katzenberg, CEO of DreamWorks Animation

There are a number of reasons someone may sell a stock, but there's only one reason to buy a stock -- you think it's going higher.

Investors can use www.insidertrading.org to find insider trading activity. Note how the shares were acquired (direct purchases or options), and if the ownership interest is increasing or decreasing.

It's ok if the manager is selling small or scheduled portions of their ownership stake. However, it's time to potentially worry when a manager begins to dump a significant portion of their ownership interest.

It's important to weigh the ownership stake compared to that person's net-worth. A manager who buys $1 million worth of stock and is worth $100 million, isn't a great indication that this manager has conviction in the business's future. Anything fewer than 10% of a person's total net worth invested in a business is just noise.

Examples of strong insider buying indicators by managers and investors:

In 2012, Dan Loeb (Third Point LLC) purchased up to 73 million shares in Yahoo (YHOO) making him the largest outside shareholder (6%). The position represented around 15% of his investment portfolio. He initiated an activist campaign on the business because of its underperformance. He pushed for a new board of directors with relevant industry experience and proper alignment of the board with shareholders.

He also believed the business was significantly undervalued with a conservative sum-of-the-parts valuation around $20 per share. His cost basis on the stock was around $13 per share. He sold the majority of his position at $29.11 per share.

Whenever you see an activist investor acquiring significant portions of his/her portfolio in a single stock, it's a strong buy signal if the business is trading well below its intrinsic value.

FIG 36: Yahoo (YHOO) Chart, 2010-2015

In early 2000, Jamie Dimon bought shares in Bank One before he officially joined the bank. His stake was almost $60 million of his own money. When he was asked why he made such a large purchase, his reply was simple: he felt that a CEO should "eat their own cooking." And I couldn't agree more. The stock was ~$30 per share when he joined the company. By the time Bank One was sold to JP Morgan in 2004 it was trading at ~$50 per share.

In early 2012, Bill Ackman (Pershing Square) initiated an activist campaign against Canadian Pacific (CP) by purchasing 14.2% of the business. The stake represented ~16% of his portfolio. His reasons for the activist campaign were the poor operating performance, poor strategic decisions, and balance sheet mismanagement.

He believed new management could act as a catalyst to converge with the businesses true intrinsic value of ~$140 per share.

FIG 37: Canadian Pacific (CP), 2010-2015

In late 2013, Carl Icahn disclosed Apple (AAPL) as the largest position in his portfolio outside of his holding company. He believed the company was mismanaging its capital allocation, and needed to put its ample cash supply to work by repurchasing its own shares.

"I'm not against the management of this company," Icahn says. "But they've just got too much money on their balance sheet…Apple is not a bank."

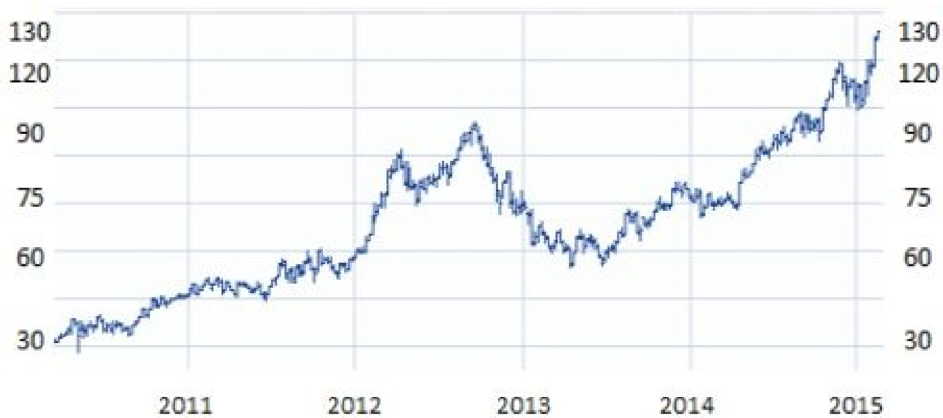


FIG 38: Apple (AAPL) 2010-2015

Examples of strong insider selling indicators:

1) If you see an insider continuing to sell their ownership stake as the stock continues to drop -- be very cautious. For example, Borders Group (BGP) saw major shareholders and officers selling shares even as stock prices dropped from $25 to $13 per share. Insiders continued to sell significant portions of their ownership until the company eventually filed for bankruptcy in early 2011.
2) If you see a large owner or multiple directors of the business selling significant portions of their ownership stake, it could be a signal that tough times are ahead. For example, from 1999 through mid-2001 29 Enron insiders began to sell significant portions of their ownership stakes. During this time, 17.3 million shares were sold for a grand total of $1.1 billion. Of course, this was right before the eventual collapse in stock prices, and the company ultimately filing for chapter 7 bankruptcy.

Are The Managers Buying Back Stock Opportunistically?

If a manager is able to opportunistically buy back its own stock, it can drastically decrease the share count of the business. All else being equal, this decrease in share count increases the value of the business while giving the investor a great percentage of ownership stake.

As seen by Henry Singleton and the Teledyne example, opportunistic stock repurchases on undervalued stocks can add incredible value to the business over time.

The number one determinate on the timing of stock repurchases is its relation to the underlying value of the business. Typically, management should repurchase shares in their undervalued stock during times of uncertainty or fear. Managers should be cautious repurchasing shares in their stock when it's trading at high multiples to cash flow or during times of euphoria such as stocks trading at multi-year highs.

There are two main motivations for management repurchasing stock:

1) To take advantage of an opportunity the market is currently presenting.
2) To offset share dilution from issuing stock options.

Let's discuss this below.

How Opportunistic Stock Buy Backs Add Value

Imagine an investor is interested in making an investment. The stock is trading at $40 per share and shows characteristics of being a high quality, long-term business. Through further analysis, the investor is able to conservatively estimate the intrinsic value of the business being worth $100 per share. During this time, the management team initiates a share repurchase program and purchases 20% of its shares at an average price of $50 per share.

The opportunistic actions of the management team effectively increased the intrinsic value of the business 10% to $110 per share ($50 per share multiplied by 20% equals $10 per share plus the $100 per share). The management team wouldn't decrease the intrinsic value of the business with any purchases above the intrinsic value. Management will create more value for shareholders the lower it is able to repurchase shares from the intrinsic value of the business (all else being equal).

Undoubtedly, there are critics who argue that stock buybacks add no value to a shareholder. Their conclusions may look correct when the data set is taken across the entire spectrum of all business that repurchase shares.

"There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds -- cash plus sensible borrowing capacity -- beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively calculated."

Warren Buffett

However, they leave out one very important element: most managers make horribly timed share repurchases in relation to intrinsic value. Some managers make share repurchases opportunistically, and many make irrational decisions that cause shareholder value to erode.

I fail to see how repurchasing shares in a significantly undervalued business with sustainable competitive advantages doesn't add value to an investor. I will humbly disagree with the critics of share repurchases all day long. Managers that make opportunistic share repurchases in undervalued shares will create extraordinary shareholder value over the long run.

The best way to determine whether a business is opportunistic in its decision making process is to look at its history. For example, Berkshire Hathaway rarely initiates stock buybacks because it uses cash to purchase other business with better long-term potential.

However, the law of large numbers has caught up to Berkshire. In order for them to grow at the rate that they once did, they would need to acquire mega billion dollar companies that exhibit the type of high quality businesses they want to acquire. This only problem is --- there aren't that many businesses that meet these qualifications. This is where the stock buy backs can add tremendous value to shareholders if done opportunistically.

As a result, they instituted a share repurchase policy in 2011, to only repurchase shares in Berkshire when the stock trades at less than 1.1 times book value of the business. It was increased to 1.2 times book value in 2012. This type of policy does two things for an investor:

1) **It tells the investor what a fair or undervalued price is of the business.** It is important that you evaluate the price to determine if it is in fact a fair or undervalued price for the business. Don't just take management's word for it.
2) Essentially management is saying 1.2 times book value is a fair value for the business. I would have to agree with them considering the quality of businesses producing excess free cash flow at very high returns on invested capital.
3) The true value of Berkshire at any point in time is probably around 1.5 to 2 times book value. And Berkshire's book value is likely to increase over time, so this sounds like a very rational and logical plan for share repurchases. Most businesses and managers would be smart and forward-thinking to initiate such policies.
4) **Effectively acts as an area of support for the business to begin buying its own stock.** As you can see in the figure below (fig. 37), Berkshire's stock was under pressure and near its 52-week lows until the announcement of the stock buyback program. Berkshire was only able to purchase less than $100 million in 2011 because that area acted as assurance to investors that Berkshire was right behind them in purchasing shares. This can have an enormously positive psychological effect on investors who are swayed by the volatility of stock prices.

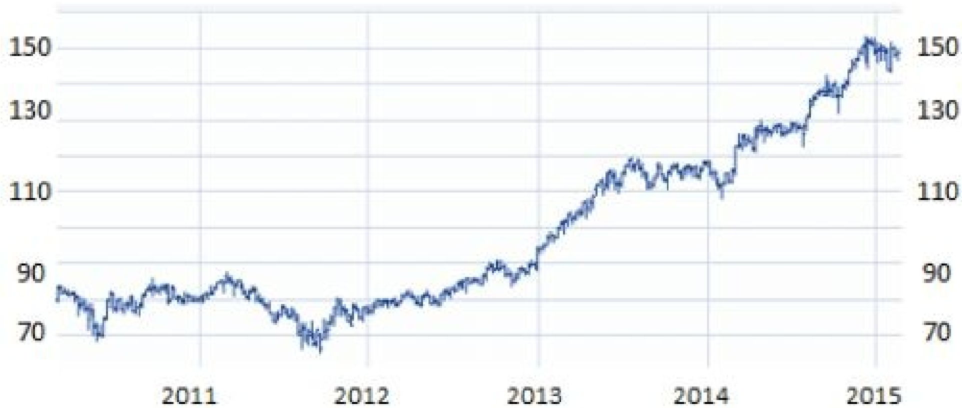


FIG 39: Bershire Hathaway (BRK.b) Chart, 2010-2015

I think we've mentioned enough how important it is for a manager to buy back opportunitically, but I can't stress that point enough. Unfortunately, it's a mistake that managers make on a regular basis.

For example, in 2011, Netflix's (NFLX) management team openly stated that their stock buyback program was not "price sensitive."

As an investor, this is the exact opposite of what you want to hear from a management team that is supposed to allocate capital effectively and efficiently. However, this seems to be the norm.

As you can see in the figure below (fig. 40), Netflix achieved great success leading up to 2011 as their subscriber base increased with revenue and profits following suit. Unfortunately, management felt they had more cash on the balance sheet than they needed.

So, they initiated a share repurchase program, and began repurchasing shares regardless of the valuation or price paid. This is a clear violation of a management team being opportunistic with share repurchases.

Netflix spent approximately $200 million to repurchase 900,000 shares of stock at an average price of $221.90 per share through the first three quarters of 2011. Management was very proud, especially as the stock price increased to $280 per share.

However, new price increases to subscribers, future content issues, and a less than ideal international expansion campaign rattled shareholders. Subsequently, share prices crashed from a high of $280 to $55 per share in the summer of 2012.

Management was repurchasing shares in a stock that was priced for perfection, and as a result has very little margin of safety. As we know, stocks that are priced for perfection can perfectly correct violently and faster than you think.

If an investor did their homework, they would have seen Netflix's questionable track record of share repurchases. Between 2007 and mid-2011, Netflix generated over $500 million in FCF, yet they purchased almost $1 billion worth of shares (mainly by issuing debt).

This was not a sound policy, and quite the opposite of what we look for in great capital allocators.

It gets more interesting though. Not only were they not opportunistic with their share repurchase program., they were also forced to sell 2.86 million shares at $70/share in order to raise $200 million for obligation coming due. By repurchasing stock at horrible prices to intrinsic value and during a euphoric period, Netflix was forced to raise capital at extremely bad terms and ultimately cost shareholders ~$1 billion.

Management consistently purchased shares at high multiples to cash flow, yet issued stock at low multiples to cash flow. Not the type of decision making and capital allocation we want as partners in our investment.

Imagine where the business would be today if management was more disciplined and opportunistic with its capital allocation and share repurchases. Where would the stock price be today?

Of course, the future is not dictated by the past actions of management (however bad they may have been). It's helpful; but it's never a panacea for making high quality future decisions.

Oddly enough, CEO Reid Hastings is a great operator; however, he proved he had a lot to learn about capital allocation. And it's easy for us to judge his decisions from the outside looking in. But he seems to be much better in his strategy for capital allocation.

As a result Netflix has continued it's current growth trajectory. Sometimes you can learn a great deal from your failures, so it's important for investors to stay flexible in their determination of the management team.

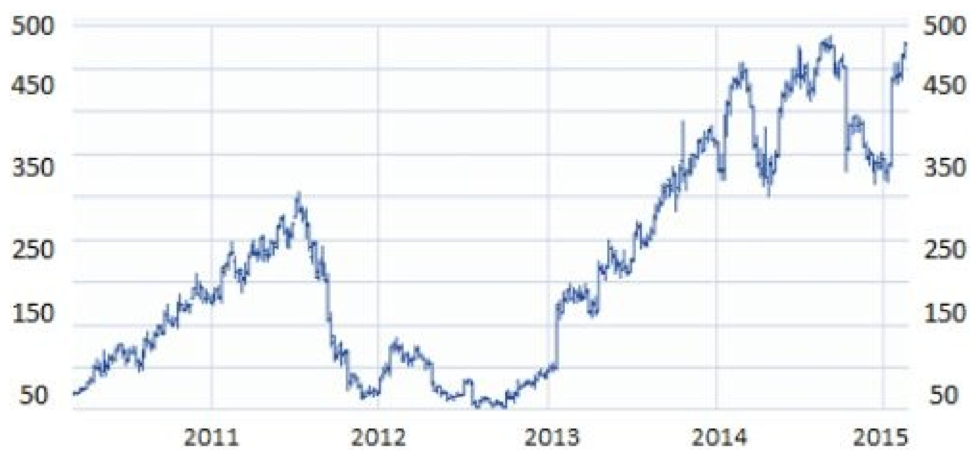


FIG 40: Netflix (NFLX), 2010-2015

An example of a business whose management team has made many opportunistic purchases is IBM. IBM's earnings per share from 2006-2014 grew at a rate of almost 100%, while its net income grew at a rate of 27%. As you can see from the figure below (fig. 41), the main reason for this difference was because of the shares repurchases the IBM made during this period. The share repurchases helped to lower shares outstanding from 1.553 billion to 995 million over the same period (or 36%).

Figure 41: IBM Repurchasing History from 2006 to 2014

Year	Shares Outstanding (in millions)	Shares Repurchased (in millions)	Earnings (in millions)	EPS with Share Repurchases	EPS without Share Repurchases
2006	1,553	74	$ 9,492.00	$ 6.11	$ 6.11
2007	1,450	103	$10,418.00	$ 7.18	$ 6.71
2008	1,387	63	$12,334.00	$ 8.89	$ 7.94
2009	1,341	46	$13,425.00	$ 10.01	$ 8.64
2010	1,287	54	$14,833.00	$ 11.53	$ 9.55
2011	1,213	74	$15,855.00	$ 13.07	$ 10.21
2012	1,155	58	$16,604.00	$ 14.38	$ 10.69
2013	1,103	52	$16,483.00	$ 14.94	$ 10.61
2014	1,010	93	$12,022.00	$ 11.90	$ 7.74
TTM	995	15	$12,023.00	$ 12.08	$ 7.74

Source: Morningstar

FIG 41: IBM Repurchasing, 2006-2015

Had IBM not repurchased any stock, the EPS would have grown minimally over this 9 year period. Surely this would have resulted in a lower stock price. However, as you can see in the figure below (fig. 42), IBM more than tripled (trough to peak) during this period.

As you can see, getting smaller to grow works!

FIG 42: IBM Chart, 2005-2015

Be Cautious Of Share Buy Backs Used To Off-Set Options Dilution

The bulk of an investor's focus should be on a management's decision and timing of opportunistic stock repurchases. However, an investor must also establish if share repurchases are being used to offset options dilution, and whether there is enough left over to provide shareholder value. An investor can create a table like the figure below (fig. 43), to see how stock buybacks are being used to offset stock option dilution.

For example, Oracle (ORCL) openly uses stock repurchases to reduce the dilutive effect of their stock option plan. The average amount of share repurchases to offset options dilution averages 16%. This leaves 84% for opportunistic share repurchases. So there’s still plenty of room to add value to shareholders with buybacks even as it is being partially offset by option dilution. Shares outstanding are still decreasing.

	2012	2013	2014
Repurchase of Capital Stock	$ 5,856.00	$ 11,021.00	$ 9,813.00
Issuance of Capital Stock	$ 733.00	$ 1,527.00	$ 2,135.00
% of stock repurchase used to offset option dilution	**12.52%**	**13.86%**	**21.76%**

Source: Morningstar

FIG 43: Oracle Stock Repurchases vs. Issuance of Stock, 2012-2014

Properly executed stock buybacks create a tremendous amount of shareholder value over the long-term. However, as we have shown, poorly executed stock buyback programs can erode shareholder value as well.

An investor should focus on the management team and their strategy for share repurchases. Are they opportunistic? Do they have ample cash on hand for future operations? Are they purchasing at discounts to their intrinsic value?

Does your manager possess the adequate capital allocation skills and strategies?

Where to Find:
10-K -- search “Stock Plans” / “Repurchase of Capital Stock” / “Issuance of Capital Stock”

For The Love Of The Game

“We look them in the eyes and ask, ‘Do they love the business of the money?”
Warren Buffett

As an investor you can sometimes overlook certain qualitative factors.

Among these qualities is how passionate the manager is for the business. If you think about how are you motivated in life, internal passion and motivation is way more powerful than financial incentive.

Now, don't get me wrong, as humans we are incentivized by a great many things. Money is certainly near the top of that list for most. However, it's been my experience that the best managers are extremely passionate about their business.

It's an important job of an investor to weight how a manager is motivated: money and power or growth and passion?

Why should an investor care about passionate managers?

In one word -- Motivation!

When I hear the word motivation I think “tough and hard working.” However, what comes to mind the most is they will do whatever it takes for the business to succeed long-term (within a moral and legal framework of course).

If you talk to successful business people and ask what made them successful, most will say they love what they do. They are incredibly motivated to see the business succeed long-term. They see the success of the business as personal success. This is a very powerful motivator in any profession or business.

“Attitude of the business is a direct reflection on the leadership of said business.”
Lukas Neely

There is a very powerful positive feedback loop that exhibits itself with people passionate about life or business. These people tend be happier, smile more and enjoy life. They bring a very powerful life force that can brighten the days of individuals. This can cause people to like you more, society will reward you more and the business will make more money eventually.

Managers will do a poor job of operating the business and properly allocating capital if they are not passionate about what they do. It can be a laborious task in trying to build a business for the long-term. If managers aren't motivated properly or genuinely interested in the business, how will they be able to see their strategies through until the very end?

"…the only way to do great work is to love what you do."
Steve Jobs

Passion turns into motivation. And motivation breeds a person with perserverance. And great things happen to people who exhibit perseverance while learning from their experiences.

So How Do You Identify Passion?

Here are some questions you should ask yourself in determining whether they are in the business "for the love of the game":

1) Would the CEO sell the business?
2) Are the managers lifelong learners with an emphasis on continued improvement?
3) Is philanthropy about attaining social status or do they genuinely care?
4) Is it a job or career for the manager?
5) Are public appearances important to the manager?
6) Is the manager motivated by the money?

Is your manager in it for the love of the game?

Where to Find:
Recent and historical articles from article archives
Lexis-Nexis
GuideStar

Is Management Incentivized Properly?

As we mentioned before, passion motivates more than money. However, it would be foolish for us to ignore our behaviors and how they are affected by certain scenarios. As humans, we have a psychological bias towards making decisions based on how we will be rewarded.

In this case, an investor should determine if the manager is incentivized and aligned properly with the interests of the shareholders (all stakeholders for that matter).

An investor should spend some time reviewing the ownership interest and compensation of management. By reviewing the proxy statement, you can gain an understanding of the character and incentive of the manager and how they will make decisions.

Here are some areas an investor should focused on to ascertain whether a manager is focus on the long-term of the business:

1) Look for managers that take little to no stock options and instead offer options to employees or other stakeholders.
2) Look for long-term performance goals in compensation plans.
3) Look for managers that own a large percentage of the business and take low salaries.
4) Look for businesses that require ownership interest in the business.
5) Look for restricted stock and bonus awards.

Here are some areas which could be in conflict to management being able to execute on its job over the long-term:

1) Be cautious of businesses that offer major equity grants to CEOs and other managers
2) Be cautious of managers that hold sizable amounts of stock options
3) Be cautious of managers continually selling large portions of their ownership interest in the business.
4) Be cautious of businesses that establish contracts for employees.

5) Be cautious of businesses that hire outside consultants to help in compensation packages.

Is your manager aligned with the business long-term?

Where to Find:

10-K

Is Management Keeping Unnecessary Costs Under Control?

"We reinvested in our people, we reinvested in innovation, and we reinvested in the values of the company."
Howard Shultz

There is a delicate balance between cost-cutting because it looks good on paper, versus truly understanding the second order effects of those cuts over the long-term. My wife is a Senior Director of operations improvement at Hospital Corporation of America (HCA), so this is a topic that comes up quite often in the Neely household.

We are usually in agreement with this topic though:

<u>Thrift is not a good strategy when the business doesn't spend money (invest) to benefit all stakeholders and their experience.</u>

I used to believe that every cost that could possibly be cut, had to be cut -- no exceptions. I look back now and see that I was very naïve. Over time I have come to believe there are second order effects from trying to cut every single cost in the business. The best managers know this already.

On the other hand, investing in the core business continually while cutting unnecessary costs is best. There is an enormous trickle-down effect with significant positive feedback loops when managers treat all their stakeholders well, while cutting the unnecessary costs.

For example, if you've visited a Costco store, you would say "What's the big deal? There's nothing too special with this store." From the outside it may look "barebones" and basic, but therein lies the appeal.

The products in the store are stacked on large warehouse-style pallets, which offers little visual appeal. However, this style also allows the customer to see more products when they visit. They come into the store to buy 3 months worth of goods, and they come out with a flat screen TV and cases of wine.

This basic layout of the store allows them to cut unnecessary stocking and marketing costs that the customer ultimately doesn't care about. Instead, Costco invests in things that benefit the customer and make sure its customers find the lowest prices on goods.

An investor should consider it a red flag if management constantly announces cost-cutting programs with little talk of re-investment in the business or its people.

For instance, retailers typically decrease labor force as a way to cut costs during times of uncertainty. They believe that this is one of the best ways to raise profit margins. Their philosophy is one of employees being a cost that can be minimized. This type of cost-cutting philosophy can have enormously negative trickle-down effect.

Think about it this way -- management decides to make labor cuts. The current workers start to become worried and nervous, even though management has assured them that there will be no more layoffs. Employees are stressed and customer service begins to wane. This causes operational issues in the stores, and this leads to a decrease in repeat customers, which then leads to a decrease in sales. Low sales leads to another round of layoffs. It’s a vicous cycle.

For example, in 2008 Starbucks (SBUX) was forced to close 100 unprofitable stores. Instead of laying off more employees across their profitable stores, they maintained the generous employee benefits and committed more assets to employee training.

They didn’t just search for cost-cutting through labor. They looked for inefficiencies in the supply chain, support and waste. As a result, customer satisfaction actually increased in 2010 to the highest level ever. The earnings and stock price followed suit. As you can see in the figure below (fig. 44).

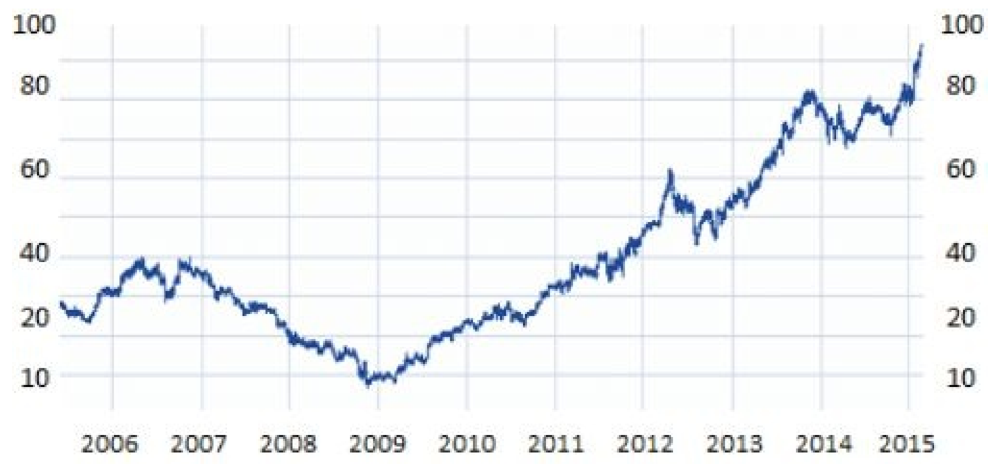


FIG 44: Starbucks (SBUX) Chart, 2006-2015

Cost cutting the right way is vital. It's important for an investor to evaluate how management is able to balance the necessary cost cuts with reinvestment in growth.

Is your manager keeping costs under control?

Where to Find:

10-K

Recent Articles

Is there A Great Culture Within The Business?

"Culture is not the most important thing, it's the only thing"
Jim Sinegal

Early in my investing days, I would focus only on things that I could measure. Mainly buying stocks at a significant discount to quantitative values. If I couldn't see it on a spreadsheet --- I didn't pay attention to it.

However, the older I have gotten, I have come to the belief that culture and human quality of a business should be emphasized more in the decision of whether or not to invest in a business (all else being equal). I've found it to be far easier to invest in great businesses and partner with great people who have instituted a culture of excellence and hard work.

Because a business's culture cannot be readily calculated, it's commonly misunderstood and often overlooked by the majority of professionals. As with most things in the world, if it can't be measured in numbers, it's often cast aside in the analysis of a business. I hope to shed some light on this very important segment of your investment analysis.

Here are some areas to focus on to determine the type of culture in the business:

1) Decentralization in the business.
2) Business is managed to benefit all stakeholders.
3) Management is focused on day-to-day operations and not a "master plan".
4) Management is truly long-term focused.
5) Employees are being recruited heavily from competitors.
6) Management is focused more on the business than appearances.
7) Management is transparent and clear in their communication with all stakeholders.
8) Employee/management turnover.

Decentralization in the business…

“There is a fundamental humility to decentralization, an admission that headquarters does not have all the answers and that much of the real value is created by local managers in the field.”
William Thorndike

There’s an interesting intangible, culture component within a business that is run in a decentralized manner. Things get done quickly and efficiently because decisions are being made in real-time by those closest to the customer.

With decentralized business structures, there is a lack of bureaucratic, top-down hierarchy with rigid structures. Decentralized businesses tend to make decisions that directly benefit the customer because they are the closest to the customer. They have a better understanding of what the customer wants.

A decentralized management structure allows for easier information flow, which means better decisions can be made for the future of the business. Some of the best performing stocks are setup in a decentralized manner because of these numerous benefits.

For example, Costco employees normally start at the bottom, and for that reason they understand the business explicitly from the ground up. Each of their managers also gets to make their own decisions. By letting the employee who sweeps the floor pick which broom to use, it means jobs get done better and more efficiently. Employees and managers both are happier and feel better about themselves.

“We would rather have our employees running our business.”
James Sinegal

Howard Schultz (Starbucks) also believes it is very wise for store managers to make decisions about that store. If trained properly, these managers know what’s best for that store location, rather than the executive team that is located 1,000s of miles away (and in many cases, disconnected from the actual customers).

Business is managed to benefit all stakeholders…

“Paradoxically, the best way to maximize profits over the long-term is to not make them the primary goal of the business.”
John Mackey

As an investor, we are constantly focused on things that will increase shareholder value or buying at a discount to intrinsic value. It's easy to forget that customer service, culture, and benefit to society are the factors that will help most to maxmize shareholder value over the long-term.

The master book on this topic is *Conscious Capitalism* by John Mackey (co-founder of Whole Foods). Conscious Capitalism is a term coined by John Mackey. This concept refers to businesses that serve the interests of ALL major stakeholders: customers, employees, investors, communities, suppliers, and the environment. Conscious capitalism is a more complex form of capitalism because it doesn't allow you to focus on just one part of a business operation.

In the book, his research partner, Raj Sisodia, showcases how the businesses that practiced conscious capitalism achieved investment returns of 1,025% over the past 10 years, compared to only 122% for the S&P 500. Being mindful of these types of companies can help an investor deliver superior returns over time.

"Long-term profits are the result of having a deeper business purpose, great products, customer satisfaction, employee happiness, excellent suppliers, community and environmental responsibility—these are the keys to maximizing long-term profits. The paradox of profits is that, like happiness, they are best achieved by not aiming directly for them."

John Mackey

www.GuruInvestorEdge.com & www.ValueInvestorConfidential.com are run entirely from this concept, and we give 10% of our revenue every year to various non-profit organizations. And we give 50% of all book sales to the *Family Resource Center* in my hometown to help struggling families get back on their feet.

We believe and support this Conscious Capitalism movement whole-heartedly, and believe that all great businesses will survive and grow through the practices of conscious capitalism.

So how do you identify these types of businesses?

Typically these businesses have 4 main characteristics:

1)Higher Purpose

This means that a business needs to be about more than just making money. Through the higher purpose, a business can inspire, engage and energize its stakeholders.

2)Stakeholder Orientation
By recognizing that a business will only succeed and survive within its ecosystem. It must ensure that all of its stakeholders are treated with the highest degree of service.

3)Conscious Leadership
These leaders embrace and understand the higher purpose of the business and the value it can create for all stakeholders.

4)Conscious Culture
These are the practices, principles, and values of the business. It's who the business is and how they treat all their stakeholders.

Who knows…this could be the true evolution of capitalism.

Management is focused on day-to-day operations – not a "master plan"…

"There has never been a master plan. Anyone who wanted to do it, we fired because it takes on a life of its own and doesn't cover new reality. We want people taking into account new information."
Charlie Munger

What's so wrong with master plans you ask? Isn't it essential for a management team to have a strategic long-term plan for the future of the business?

In a sense -- Yes.

However, we also know from history and experience that a great many businesses have been hurt by their inability to be adapt to the situation around them at that one moment in time.

The issues with master or strategic plans stems from the human brain deviating from prior commitments. Robert Cialdini wrote about the "commitment and consistency principle" in his book, *Influence: The Psychology of Persuasion* (highly recommend this book).

The commitment and consistency principle simply states that if a person commits (orally or in writing) to something (idea or goal), they are more likely to follow-through on that commitment because to do otherwise would be a blemish on their self-image.

Charlie Munger describes how IBM came into existence without a master plan during the Wesco 2004 annual meeting.

He states, "Look at the guy who took over the company that became IBM. At the time, it had three equal sized business: [a division that made] scales, like those a butcher uses; one that made time clocks (they bought this for a block of shares, making an obscure family very rich); and the Hollerith Machine Company, which became IBM. He didn't know this would be the winner, but when it took off, he had the good sense to focus on it. <u>It was enlightened opportunism, not some master plan."</u>

"I happen to think great cities develop the way IBM or Berkshire did. I think master plans do more harm than good. Anyway, we don't allow them at Berkshire, so you don't have to worry about them."

"Our main business is not to see what lies dimly in the distance but to do what lies clearly at hand."
Thomas Carlyle

The point of this section is not for an investor to disregard all strategic and master plans. Simply, an investor should be cognizant of historical or future biases that could keep a management team from acting opportunisitically when the situation calls for it.

Master plans fail because when opportunity presents itself, and it doesn't fit with the strategic vision of the company, then it is disregarded as "non-strategic." Management teams that shut out opportunities that weren't expected, will put themselves at a severe disadvantage against nimbler and more flexible competition.

Does your manager follow a "master plan"? Or are they focused on the day-to-day operations?

Management is truly long-term focused…

"Management is all about managing in the short term, while developing the plans for the long term."
Jack Welch

Long-term planning and goals shouldn't be confused with master and strategic plans. Long-term planning is the vision of the business long-term. Quarterly and short-term results don't mean a great deal unless it severely erodes the future of the business. They will gladly go through the pain of today, for the reward of tomorrow.

In planning for the long-term, these managers typically never use hard financial figures to determine their success long-term. For instance, the business will seek to become the lowest cost producer to the consumer or seek to become the business with the highest ranking for customer service satisfactions. These are long-term plans that will directly affect the top and bottom lines of a business if executed correctly by management.

It's better than reaching for some arbitrary number, which can cause a manager to do things that jeopardize the culture and future of the business.

One of the toughest tests a manager will face during his/her career is the ability to sit still and do nothing while others are gaining mightily around you.

For example, John G. Stumpf, CEO of Wells Fargo, didn't participate in the risky and leveraged activity of his competitors as they went after poor quality mortgage backed securities in hopes of increasing and meeting profit numbers. Leading up to the eventual crash in 2008, Stumpf was questioned by Wall Street and shareholders for being too conservative, and that they needed to grow in order to keep up with the competition.

As we know, Stumpf was one of just a few CEOs who managed to not only make it out of the chaos relatively unharmed, but Wells Fargo strengthened its business during this time of uncertainty.

Many of Wells Fargo's competitors threw out their company values and risk-management policies to hit numbers that were part of their long-term strategic plan. Instead of seeing these mortgages for what they were (trash), they felt it was a way for them to get to their master plan.

Stumpf was willing to forego an underperformance in earnings short-term, because he believed that purchasing these low-quality assets weren't part of Wells Fargo's long-term plan.

Is management "really" focused on the long-term?

Employees are treated incredibly well…

This is another area of focus that can be a direct window into the culture of the business.

In many businesses, employees are treated as short-term commodities instead of long-term assets. Just like great long-term assets, great employees need to be maintained and upgraded to maximize their value.

As we discussed previously, there is a positive feedback loop from employee morale and happiness.

Happy Employees + **Happy Customers** + **Better Customer Experience** = **Higher Profits**

When employees are passionate about the business, and feel like they are partners with their managers, morale and customer service increase. Higher profits are a byproduct of this in the long-term.

Here are some areas to focus on to determine how management treats its employees:

- Employees are paid at or near the top of their industry
- Employees receive excellent benefits
- Employees aren’t laid-off during recessions
- Employess are trained extensively at their positions
- Management talks about the employees contributions
- Management has very low employee low turnover

Does the business treat its employees well?

Management is transparent and clear in their communication with all stakeholders…

You look for three qualities: integrity, intelligence, and energy. And if you don’t have the first, the other two will kill you. You think about it; it’s true. If you hire somebody without [integrity], you really want them to be dumb and lazy.”

Warren Buffett

The best managers communicate to stakeholders in a clear and concise manner that is easily understood. If management makes it difficult to understand it’s likely they want it to be that way for a reason. Confusing and complicated financial statements or press releases should be a red flag for investors.

Accountable and straightforward management teams are incredibly transparent. They normally confront adversity and mistakes head-on, leaving very little room for uncertainty and speculation. These types of managers never make excuses, own up to the mistake and try to fix the problem. There is little wasted energy dwelling on the past.

Truth and humility are traits to be coveted in a management team. It goes a very long way in determining the character and culture of the manager and the business in general.

A trick to finding transparent management teams would be to see if the management team takes questions for an extended period of time when quarterly and annual reports are released. This shows that management wants to be as accommodating as possible. There is very little to hide in a true Q&A session.

Is management being completely transparent in its communication with all stakeholders?

Ultimately, a business's culture sets the tone for how employees and management interact and treat the stakeholders they come into contact with on a daily basis. Determining a business's culture can give an investor a good idea if this business is likely to continue providing value to its customers. This will have a direct impact on the success or failure of any investment.

Does your business have great culture?

In this section, we learned how to:

1) Find businesses with sustainable competitive advantages,
2) Ascertain the "real" earnings of a business,
3) Pinpoint and identify catalysts,
4) Determine whether a business establishes proper debt control, and
5) Determine whether management will be a great partner in your investment.

In the next part we will learn how to Master Your Margin of Safety (valuation and investment).

Let's get started!

PART 5: MARGIN OF SAFETY MASTERY

Is There A Difference Between Perception And Reality?

"The margin of safety is always dependent on the price paid. For any security, it will be large at one price, small at some higher price, nonexistent at some still higher price."
Benjamin Graham

It took two years, but the construction of the 40-story Hyatt Regency Hotel in Kansas City was finally complete. Everyone was ecstatic that all the hard work and perseverance had paid off on building this remarkable structure.

One of key defining features of the hotel was the lobby, which showcased an atrium with walkways suspended from the ceiling. The walkways weighed ~64,000 lbs. and were 120 ft. in length. Little did they expect that disaster was about to strike.

On the evening of July 17, 1981, the unthinkable occurred:

The walkway collapsed, killing 114 people and injuring more than 200 others during a tea dance. It was the deadliest structural collapse in U.S. history at the time.

Construction deficiencies and calculations led to a small, but flawed design that doubled the load on the walkway leading to its ensuing collapse. The design could barely hold the weight of the walkway itself. When the hundreds of spectators stood on the walkway, their fate was near certain.

Investment transactions and decisions are eerily similar to the processes of engineers. I have a tremendous amount of respect for engineers and their thought processes. So maybe it's just my way of hoping that I can be put on the same platform of engineers. Either way, it is difficult to ignore the similarities.

Normally, engineers build in a significant margin of safety in any structure they build. If you are building a bridge that will normally carry 15,000 pounds across it, you insist that it can carry 50,000 pounds for extra safety.

The same rule exists for investing. As investors, we always want to make sure we are buying at a margin of safety from the intrinsic value of the business.

Ignore the margin of safety principle, and your investment could end up like the walkway in Kansas City.

Value investing entails purchasing a security at a discount from its current value and then holding that security until that value is realized (or something changes). Because we, as value investors, are always searching out bargains, we have built in the margin of safety principle into our mental models already. We just need the discipline and the patience to follow through on the strategy.

No one wants to buy a dollar for a dollar. We are trying to buy a dollar for fifty cents. Essentially, that's all we are trying to do as investors. We do this through conservative analysis of the business.

However, there is another feature to investing than merely valuing securities conservatively. This practice must be combined with the patience and the discipline to purchase that security at a significant margin of safety from the conservative valuation.

There are times where bargains are everywhere (consider yourself lucky) and there will be times when it seems you can't find anything with a margin of safety (and that is ok).

The margin of safety will also vary. Sometimes the difference between price and value is wide and there will be times when it is not. There will be times when you research 10 businesses without finding a single one with a margin of safety. This is part of the discipline and part of the process of finding the bargains with a margin of safety.

<u>Persistence is not only the secret of life, but it is the secret of investing as well.</u> No one will tell you about them. You have to go out and find them yourself.

The very process of value investing itself makes it a very risk averse strategy. Of course this means nothing if we are not disciplined enough to stay within the system. Being a value investor means it will be lonely at times.

However, you must have a streak of contrarianism in you during certain periods if you are to succeed long-term at investing. It is how it must be. It is the law of numbers that if you are doing what everyone else is doing, you will revert to the average. And we don't want that.

If you run a focused portfolio, performance may be bumpy from time to time. This never bothered me, but I know everyone has their own threshold for volatility.

I would rather a bumpy ride of 15-20% return over 15 years, than a mediocre 8% or less. I am able to remain calm and see these types of strategies through because as value investors we know stock prices tell us very little about the performance of the business or its intrinsic value.

I will no doubt underperform for certain periods of time and it will be difficult to watch as others revel in their glory.

However, I know from experience that value investing through 5M™ will work very successfully over the long-term. Value investing is both practical and logical. There are very few things I will never abandon: my wife & family and the 5M™ Mental Model of value investing.

Waiting For The Fat Pitch…

"In investments, there's no such thing as a called strike. You can stand there at the plate and the pitcher can throw the ball right down the middle, and if it's General Motors at $47 and you don't know enough to decide General Motors at $47, you let it go right on by and no one's going to call a strike. The only way you can have a strike is to swing and miss."
Warren Buffett

Warren Buffett is an avid baseball fan and loves to use the analogy of Ted Williams to describe how an investor must have discipline to wait for the right opportunity.

Just as great hitters like Ted Williams had infinite patience to wait for the right pitch, so must value investors be willing to wait until the right opportunity when a security is trading at a significant discount to its underlying value. <u>The best part about investing is that there are no called strikes.</u> You can wait as long as you like for the right pitch and then swing aggressively.

Investing within your circle of competence is obviously essential as well. If you cannot understand a business or have a difficult time valuing it, then walk away. Throw it in the garbage bin, and move on to the next opportunity.

There is no shame in knowing where not to invest. In fact, it may be the best trait as an investor. Most value investors shy away from technology companies and financial services businesses. I for one, feel I have a very good understanding of a few technology and financial services businesses, so I have no trouble investing in these businesses if given the right opportunity.

The great thing about being a value investor is that you do not need to be fully invested all the time. Most institutional investors (even if they are value investors) have an obligation to their investors to be invested at all times.

This puts an enormous amount of stress on an investor to have to swing at pitches you have no business swinging at in the first place. Likewise for amateur investors, they will swing wildly at pitches because they cannot discern a good pitch from a bad one. This propensity to constantly swing wildly at pitches is the norm in the stock market. This is why so many fabulous opportunities can present themselves at any moment.

"...that's exactly the philosophy I have about investing... Wait for the right pitch,

and...wait for the right deal. And it will come... It's the key to investing."
Warren Buffett

If you are not "really" compelled by an investment opportunity, there's no reason to lift that bat off your shoulder. It needs to just jump out at you. And after knowing what great investment opportunities look like, you will know when these kind of situations present themselves.

Never invest just for the sake of investing. You need to have some inkling of what you are doing. 5M™ and MECOM™ Method help with this.

Even the cheapest security in an overvalued market can be a bad investment, if you believe that it could become much cheaper if the market corrects. So it's important to weigh all options in your current environment.

Opportunity Cost…

"A bird in the hand, is worth two in the bush."
Aesop

As an investor you know you must buy at a price that you believe is a discount from the underlying value.

But what happens if there are multiple bargains at the same time? How do you distinguish which ones offer better value than the other ones? Do I invest in the one trading at 60% of the underlying value or the one that is trading at 30% of the underlying value? What if one of the investments has a greater probability of value realization than the other?

This is the ongoing quandary that an investor must face as they search out opportunities and investments.

And the best absolute value may not always be your best investment choice. As focused value investors, we want no more than 10-15 investments in our portfolio at any one time. As you build up to that number of investments in your portfolio, every decision you make will be based on whether it's a better investment in comparison to any of your current holdings. This is opportunity cost at its finest in action.

With every investment decision you make you must have an understanding of the opportunity cost. <u>Great investors only think in opportunity costs.</u>

Constantly comparing new investments with your own positions in order to find the best portfolio of undervalued businesses is great investment practice. As an investor you should never be scared to scrutinize and critique your current holdings.

The most difficult part of this process is selling current positions at a loss because the new investment offers better value realization. However, in my opinion, this is a sign of a great investor. One that is both rational and un-emotional when it comes to making investment decisions.

For example, I went through this exact scenario in late 2011/early 2012. During this time, I wanted to know more about the oil and gas industry and its fundamentals and industry dynamics. I had just completed a great deal of research on the natural gas sector, and was interested in the industry's future potential.

All that was left was picking a likely long-term winner in the group. Despite its current issues, the company that I believed had the biggest risk/reward potential over the long-term was Chesapeake Energy (CHK).

After going through my 5M™ and the MECOM Method, I knew this was a business I wanted to own for the long-term. When I finally made the decision to start accumulating a position, I had some decisions to make with the rest of my portfolio.

"Any year that passes in which you don't destroy one of your best loved ideas is a wasted year."
Charlie Munger

After much deliberation (with myself), I made room for Chesapeake by selling a great deal of my portfolio. Mainly investments at (or near) my calculated intrinsic values, or investments that had probable risk/reward scenarios less than Chesapeake's.

But the most painful part was selling certain investments at a loss to make room for my investment in Chesapeake. These positions were sold even though I still believed they would make great investments long-term. However, I felt Chesapeake offered better potential long-term.

Chesapeake comprised over 20% of my portfolio at one point. These are the tough decisions that must be made at times to achieve superior absolute returns. No one investment should be 'untouchable' if a better opportunity comes along.

BOTTOM LINE: An investor must maintain a focused discipline to the valuation process while comparing opportunities to your current holdings. This must be done when opportunities are scarce, as well as when they are plentiful. Being honest and conservative through the entire valuation process can be a difficult endeavor when opportunities are scarce. So investors must stay true to themselves and their process.

If you remember, in the last section we explained The MECOM™ Method, and how it provides a simple, step-by-step method for analyzing any business.

Since you now have mastery of The Market, Your Mindset, Your Morals and The MECOM™ Method, we will now dive into detail on Mastery of Your Margin of Safety.

In this part, we will learn how to value a business.

By the end of this part you will know how to:

1) Practice the Art of Valuation
2) Use a range of values in your calculation of intrinsic value
3) Use discounted cash flow valuation (DCF)
4) Use liquidation valuation (LV)

The Art of Valuation

"Organized common (or uncommon) sense is an enormously powerful tool. There are huge dangers with computers. People calculate too much and think too little..."

Charlie Munger

Let's get this very important concept out of the way right now: you will never know ALL the facts and figures that will lead to the best investment result. It's inherently unknown.

Many investments are reliant on outcomes that are not fully known or predicted. Coming to grips with the fact that you won't know everything about a business before you invest can be very difficult for many investors. This is why it's so important to have a mental model of checklists that help you zero in on the most important variables to investment success.

So how can you accurately value a security then?

Well the simple answer is you can't value any security with 100% accuracy. The best you can do is carefully and conservatively value securities if you are to truly achieve a margin of safety over the long-term.

This is where many investors give-up, and run for the hills. Don't stress. Conservative templates for valuation are provided in the following pages, and at the end of this book. These will give you a baseline on how to value businesses using a range of conservative values and outcomes.

Even if you knew everything about a business, it wouldn't give you the ability to value that business perfectly. It is virtually impossible. Investing would be much easier if businesses moved in a static and predictable manner over the long-term, but this will never happen.

Businesses within a capitalist system are very dynamic and constantly changing and evolving due to competition. The best you can do as an investor is to approach valuation of a business in a very simple and conservative way.

There are three major factors that can cause business values to fluctuate wildly because of forces outside the operation of the business:

1) Interest Rates,

2) Trends In Inflation/Deflation, and
3) Credit Cycles.

1)Interest Rates:

An interest rate is essentially the cost someone pays for the use of another person's money. So the fluctuations in interest rates can greatly affect the behavior of consumers and businesses. This will ultimately affect the stock market and its components.

Typically, lower interest rates means more borrowing, which means people have more money to purchase things. Which means inflated prices.

Typically, higher interest rates mean less borrowing, which means people have less money to purchase things. Which means deflated prices.

It's important to note that there is usually a "lag-effect" to the timing of the scenarios above. Normally, there's an underlying cycle associated with interest rates that is very similar to commodities:

High prices tend to lead to low prices. And low prices tend to lead to high prices. The timing is the main issue.

For example, if interest rates begin to decrease from high levels, it's likely that the economy and consumer aren't doing as well as previously thought. It could be a sign that valuation and asset prices are fully valued. Conversely, if interest rates start to stabilize or increase from low levels, it's likely the economy and the consumer are doing better than expected. It could be a sign that valuation and asset prices are undervalued or stable.

As we will discuss shortly, interest rates effect the discount rates for the Discounted Cash Flow calculation.

2)Trends in Inflation / Deflation:

Inflation / deflation trends can have a drastic outcome on the value of businesses.

During an inflationary environment, investors can do very well. Think about it -- as value investors we are always trying to purchase future free cash flow or assets at a discounted value. If the value of goods and services, as well as tangible assets increase over time (which they more than likely will), you will be in a great position and it affords you an even greater margin of safety. Real estate, as well as various commodities, tend to increase over time with inflation.

Thus, if you are buying a business that is trading at a 60% discount from its tangible book value, your margin of safety could be greater if you expect an inflationary type environment. Of course, it's during such periods of inflation that market folly can take over and the reptilian or animal brain takes over. This is why it's always prudent to value securities in a very conservative manner.

Personally, I have found interesting opportunities in companies that are trading below tangible book values, but also have an added kicker in the form of "hidden assets." Peter Cundill, in his book *There's Always Something to Do*, talks openly about investing in securities with hidden assets. His approach intrigued me greatly, and I highly recommend the book. Although my philosophy has shifted more to great businesses at reasonable prices, I continue to search out hidden assets to provide an even greater margin of safety.

During deflationary environments, assets and markets tend to decrease in value. So buying a security at a 60% discount from tangible book value may not give you the margin of safety you expect if assets are decreasing in value. Of course, this depends on how the assets are recognized on balance sheet as well.

In deflationary times, these hidden assets can easily become impaired. Real estate carried on the balance sheet at historical cost could decrease below historical cost, over funded pensions can be eroded and subsidiaries within the parent company can encounter difficult business environments during a deflationary period.

A prolonged deflationary environment can wreak havoc on the market. This is normally an investor's worst nightmare.

This is always a possibility as an investor. Anything could happen in the markets at any time. In a manner of speaking, an investor should expect the unexpected.

The best case scenarios for long-term investors are bouts of deflation. It is not fun to be in the middle of a deflationary market environment. No one wins in a deflationary environment short-term.

However, it's during these periods that investors can accumulate positions in great businesses at incredible prices. The only way to invest during deflationary environments is with a significant margin of safety, and even then it may not be easy.

This is the essence of value investing. We have to come to grips with the fact that there are many things that we will not know when it comes to investing. Are we entering a period of inflation/deflation? How large should the margin of safety be in an inflationary environment versus a deflationary environment?

There is no hard figure or answer to these questions. If you believe there could be further erosion in prices, then maybe you want a greater margin of safety. Maybe you let more opportunities go by because you feel you may have better opportunities down the road.

There are many questions to which the answers are unknowable.

The only prudent act of an investor is to perform security valuation in a very conservative manner. Give preference to liquidation value (worst case scenario) and then free cash flow. Specifically, you want businesses trading below liquidation value with hidden assets.

These are more of your “active value” or “cigar-butt” type of investments, however they yield a very large margin of safety because they are trading as if the business is dead. Even if the business is dead, you can still reap investment gain because of the margin of safety.

Next, you give preference to businesses with sustainable competitive advantages that produce free cash flow. These are the high quality businesses that will be able to withstand prolonged periods of deflationary forces (and inflationary too). In fact, many of these businesses come out better in the long run because they are able to increase market share as lesser quality businesses end up insolvent or bought out by the higher quality businesses.

This is another reason why the MECOM™ Method focuses so much on catalysts. The ability to invest in businesses that have catalysts, helps increase your margin of safety and bring about value realization over a shorter time period. In a deflationary environment, this can mean the difference between success and failure.

BOTTOM LINE: Never relax your conservative standards of valuation, and always insist on a wide margin of safety. Practice this in any environment, and you will certainly be better prepared than your peers. Over the long term, it will serve you well.

3)Credit Cycles:

Credit cycles dictate the amount of available credit that enters the market. The tightening of credit (less credit) can decrease valuation and market levels. The easing of credit (more credit) availability can help to increase valuation and market levels. In a sense, credit cycles can give you an idea of the psychological state of the market as well. See the simplified credit cycle below (fig. 44).

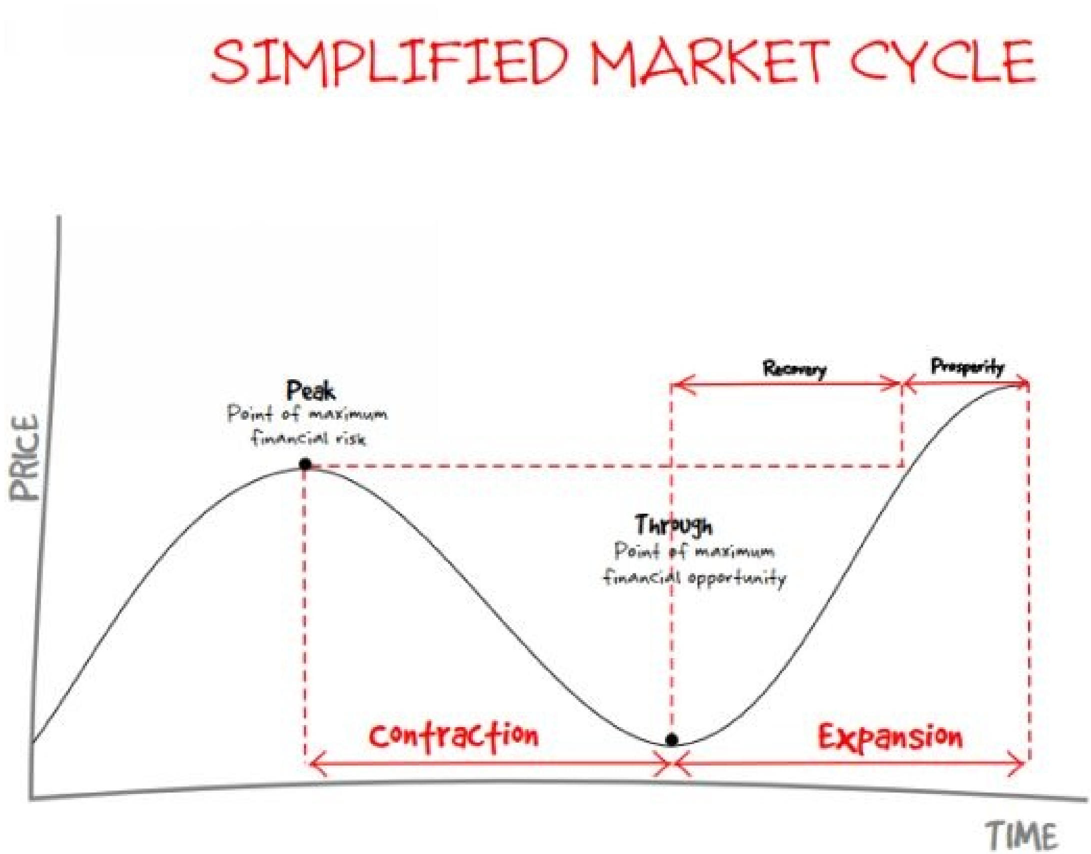


FIG 45: Simplified Market / Credit Cycle

It’s important to have an understanding of potential inflection points in a credit cycle. You need to be able to know where you are: are you in a period of tightening credit, or are you in an environment of easy credit? Next you need to ask whether that environment will last.

Generally, buyers are willing to pay higher multiples if they receive low-rate financing (nonrecourse). Of course the paying of higher multiples with easy credit can lead to overvaluation, potential folly and irrational behavior in the market place. Credit cycles are a result of the fed’s fiscal policy regarding interest rates and the banks’ ability to lend that available credit to worthy borrowers.

Howard Marks, founder of Oaktree Capital Management, discusses this subject in his book *The Most Important Thing*. In the book, he discusses how understanding where you are in the credit cycle is vital to creating a competitive advantage for yourself as an investor. He says that there are “no structural inefficiencies anymore…I call this process ‘efficient-isation’, and it’s the norm.” However, he does believe that cyclical inefficiencies still exist. He says, “People do panic at the lows and sell, or at least fail to buy.”

This is a very important concept because the same can be said for the market’s action during market highs. Having an understanding of credit (psychological) cycles can have a profound effect on your investing results.

Focus on the Downside…

“Focus on the downside, and the upside will take care of itself.”
Mark Sellers

As an investor, your primary goal is to eliminate the possibility of permanent loss. This means I spend the majority of my time calculating the valuation of a business in its worst case scenario before I ever think about buying it. I hate losing money more than anything.

So how does one eliminate the possibility of permanent loss while trying to grow your wealth?

NEVER purchase a security that is trading above its conservative estimation of intrinsic value!

Of course, permanent loss doesn’t mean paper losses from stock price volatility. A stock could easily decrease further in the stock market after you purchase. If you invest long enough, you know that this is a foregone conclusion (usually instantly). Bruce Berkowitz, calls this ‘premature accumulation.’ He says he’s always suffered from it. It makes me laugh every time.

In value investing, you must grasp the fact that a security will probably go down further after you buy it. Trying to time the market is a fool’s errand. Very few have been able to time the market consistently over the long-term. As an investor, you can look very silly for a long period of time before ultimately being proven correct.

Permanent loss occurs when you purchase a security with no margin of safety, and the stock goes down and stays down, never to come up again, due to poor business fundamentals. I know this doesn’t fit the classic definition of permanent loss, but I also define it as a security that has a high likelihood of not increasing for many years. The opportunity costs are too great if this is a real possibility. So I include it in the permanent loss category.

In these cases, it’s likely an investor purchased above the conservative intrinsic value of the business or miscalculated the underlying competitive dynamics of the business or industry.

However, this isn’t the only scenario in which permanent loss occurs.

The scarier scenario is that you purchase at a point that you deem a margin of safety, and the stock continues to fall. And upon further analysis and re-valuation of the business, you realize the valuation has fallen below the new stock price (I hate when that happens).

This can have disastrous effects emotionally and financially, which is why I try to focus on the worst case scenarios when valuing businesses.

REMEMBER: Day-to-day, week-to-week, month-to-month and year-to-year volatility is not risk. Volatility is classified as risk if you know nothing about the business (beta), or you have a short-term time frame. The fundamentals of the business will show you the true risk of your investment.

By purchasing securities at a discount to their readily ascertained liquidation values or highly predictable (and sustainable) future cash flows, an investor is unlikely to experience permanent losses. This purchase at a discount to the intrinsic value of the business says that you demand a margin of safety, and that you are very risk averse. Adhering to this strategy over time is likely to produce outsized returns with a low probability of permanent loss.

“Many shall be restored that now are fallen and many shall fall that now are in honor.”

Horace

Because investing is imprecise, more art than science, it is only logical that investors ALWAYS seek that ever elusive margin of safety. This margin of safety in any investment allows for the imprecision that is investing. And it allows for bad luck, or even analytical errors in understanding the underlying business fundamentals.

Unless you have a crystal ball or live in Disney World, the future will always be unpredictable. Although you may be able to use probability in a number of different scenarios, it is most prudent to always seek a margin of safety in any investment.

Although most of the trading today is accomplished through algorithmic trading, these algorithms are controlled by humans. AND HUMANS MAKE ERRORS AND MISTAKES. Opportunities will happen more quickly and much more frequently because of the speed of technology. Most of these mistakes are more out of temperament than intelligence, but mistakes happen nonetheless.

This Margin of Safety philosophy is probably the most common characteristic of EVERY great investor. They know that valuation is imprecise, and that markets are controlled by emotion. They are willing to wait for that elusive Margin of Safety --- that moment when they see the difference between perception and reality.

Appropriate Margin of Safety…

The appropriate margin of safety can vary from business to business, and from investor to investor. There are higher quality valuations than others, just as there are higher quality businesses than others.

Ideally, a business that is in Chapter 7 Liquidation proceedings, and is trading below liquidation value would be the highest quality margin of safety. This would be followed by businesses trading below readily ascertainable liquidation value in the open market (and not bleeding cash), and then would be purchasing business trading at a discount to predictable free cash flows of high quality businesses. The latter is where I focus the majority of my energy. However, all of these provide very sound value investing philosophies for an adequate margin of safety:

1) Businesses trading below liquidation value in Chapter 7 Liquidation proceedings
2) Businesses trading below readily ascertainable liquidation or net-net value (not bleeding cash)
3) Businesses trading at a discount to predictable free cash flows of a high quality business

**All other businesses fall underneath this list regarding the quality of the margin of safety.*

It's not commonplace in the stock market to demand a margin of safety. This simple concept escapes the great majority of market participants, sometimes even the great investors as well. Index Funds and Mutual Funds all fail to achieve adequate levels of margin of safety because they feel the need (or pressure) to be invested at all times.

Many hedge funds and private equity funds fall into this category as well. Investors that trade or invest in momentum and ultra-growth businesses also do not employ an adequate margin of safety in their portfolios. They view their holdings as pieces of paper to be traded on a regular basis, regardless of underlying value. There is usually very little margin of safety surrounding Wall Street underwritings and innovations. After all, they get paid commissions by creating buying interest and hype around these products.

At times, value investors can have issues understanding what constitutes a reasonable margin of safety. There is no hard line in the sand. Every situation is different. However, approaching valuation in a very conservative manner will certainly help.

Many investors now use intangibles in their rationale of what constitutes margin of safety. Moat investors believe it's through intangibles, such as culture or proprietary formulas and processes, that the business is able to produce outsized free cash flow and returns on capital over long periods of time. Thus, it makes sense for them to incorporate these sustainable competitive advantages into what constitutes a proper margin of safety.

I tend to agree. However, I still want the tangible elements too. I am always on the lookout for moat businesses that are trading below liquidation value. This gives me an incredible margin of safety, and allows me to invest heavily because of low probability of permanent loss.

The problem with intangible assets is that they can lead to subjective opinion at times. In addition, moats can be penetrated due to the competitive nature of capitalism.

For example, right now Tesla Motors (TSLA) trades at incredibly high multiples to book value and cash flow. I would venture to say Tesla's most valuable asset right now is its people (Elon Musk), and its new exciting entry into the electric car business.

What if something happened to Elon Musk? What happens to the multiple the market is willing to pay for the stock when other auto businesses, which are just as competent, begin to enter the category and take back their market share?

Something could go wrong quite easily when you pay that high a multiple for a business as it's already priced for perfection. There's no margin of error. Customers' perceptions can change very easily and quickly, and competitors are always looking to storm the castle. Anything less than perfect execution from the company can result in permanent capital loss from investors when you pay extraordinary multiples to tangible book and free cash flow levels.

In this case, the margin of safety would not exist.

<u>If you want a greater margin of safety from permanent loss, tangible assets can provide you with the protection you seek.</u>

In addition to tangible assets being used for the day-to-day operation of the business, tangible assets can serve another role as well. If something unforeseen happens to the business, real estate can be sold, receivables can be collected and inventories can be wholesaled. If customers suddenly lost their taste for electric cars made by Tesla, its tangible assets would not be able to save investors from permanent capital losses.

This begs the question again: how can you be sure you are receiving an adequate margin of safety?

- By always purchasing securities at substantial discounts from conservative valuation levels (at least 50-60% of conservative estimates of intrinsic value).
- By thinking worst-case scenario first and foremost for valuation. This means putting emphasis on tangible assets and purchasing below liquidation level (non-cash burn businesses).
- Next, you put emphasis on moat businesses with substantial free cash flow generation.
- Always review current holdings against new ideas, and only sell when a better bargain comes along, the security has reached fair value or the business deteriorates to a point where you could sustain permanent capital loss.
- Never be scared to hold substantial amounts of cash. Opportunity favors the prepared mind. If the market is too euphoric and you are not able to find many ideas, hold cash and wait for the right pitch. It will come eventually.
- Diversify enough to reduce risk. This means no more than 10-15 of your best investments in the portfolio at any one time.
- Purchase cheap out-of-the-money put options to hedge your portfolio when it's appropriate to do so (i.e. during long and/or extreme bull markets). This should comprise no more than 1-2% of your portfolio. I will explain this later.

Second Level Thinking…

"First-level thinking says, 'It's a good company; lets buy the stock.' Second-level thinking says 'It's a good company, but everyone thinks it's a great company, and it's not. So the stock's overrated and overpriced, let's sell."
Howard Marks

Once you find an undervalued security trading at a substantial discount to your estimate of intrinsic value, your job is not over.

The next question you must ask yourself is "Why is the security trading at this level and what catalysts will lead to its eventual reversal?"

If you cannot answer this question, you should not be investing in the stock. Howard Marks calls this second level thinking, and it will keep you from falling into a value trap.

To see the margin of safety concept and second level thinking in action, consider my investment in Chesapeake Energy in 2010/2011. It was backed by the largest oil and natural gas acreage in the U.S., and its various profitable subsidiary businesses in the oil and gas sector which could be spun-off. Chesapeake was on my watch-list for a very long time, but now it was trading below my back of the envelope value of the business based on its oil and gas assets. So now it was time to dig in a little more.

There was much uncertainty surrounding the company, from its extreme debt load to plummeting natural gas prices. Also, its CEO, Aubrey McClendon, grabbed headlines on a daily basis for all the wrong reasons. My main concern was the debt level and the natural gas prices. I knew I had to be careful in this investment because it is a commodity company, and is subject to the whims of natural gas prices.

I began with natural gas prices because it wouldn't matter how great the assets were if they would have to be written down for an extended period of time because of low natural gas prices.

The natural gas shale revolution had taken hold. Supply that was thought of as lost forever, suddenly was available because of new technology in horizontal drilling and fracking. This increase in supply drove natural gas prices from a high of $13.50 in 2008 to $2.00 in 2012. See the figure below (fig. 46)

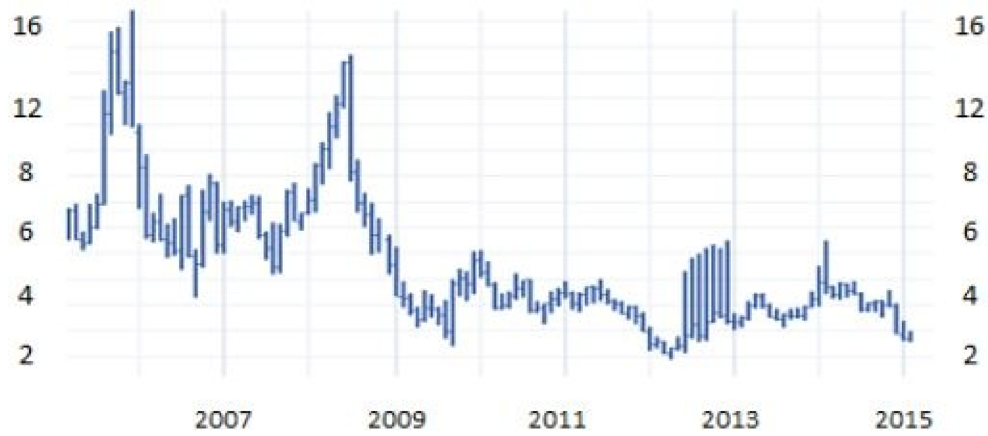


FIG 46: Natural Gas (NG1) Chart, 2006-2015

The continued drop in natural gas prices caused a panic in the natural gas sector. This allowed me to do even more homework on the sector as everyone was busy selling around me.

First-level thinking says, ‘The outlook calls for low growth and rising inflation. Let’s dump our stocks.’ Second-level thinking says, ‘The outlook stinks, but everyone else is selling in a panic. Buy!’
Howard Marks

My findings were quite interesting: natural gas prices were trading at an extreme level, well below the average cost of production. This means businesses would be losing money hand over-fist if they continued to produce at those natural gas price levels. I reasoned that over time, it was likely that natural gas would trend back towards its average cost of production. And Chesapeake, being a low cost producer with incredible assets, would be able to weather the storm.

Not only did the producers decrease drilling and production, but there was an uptick in demand as well, because natural gas was cheaper than oil and coal on a BTU basis.

Utilities started switching from coal to natural gas. And the transportation sector started to take strides to convert to natural gas. It was a cascading effect which helped to increase and stabilize natural gas prices.

Once I was able to get my head around its obligations and its incredible portfolio of acreage throughout the U.S, I deemed downside permanent capital loss to be near zero. I soon realized that Wall Street’s concerns over the debt issues were massively overblown. Uncertainty about the future, and exact execution of the business, created an incredible opportunity for investors who were content with a substantial margin of safety.

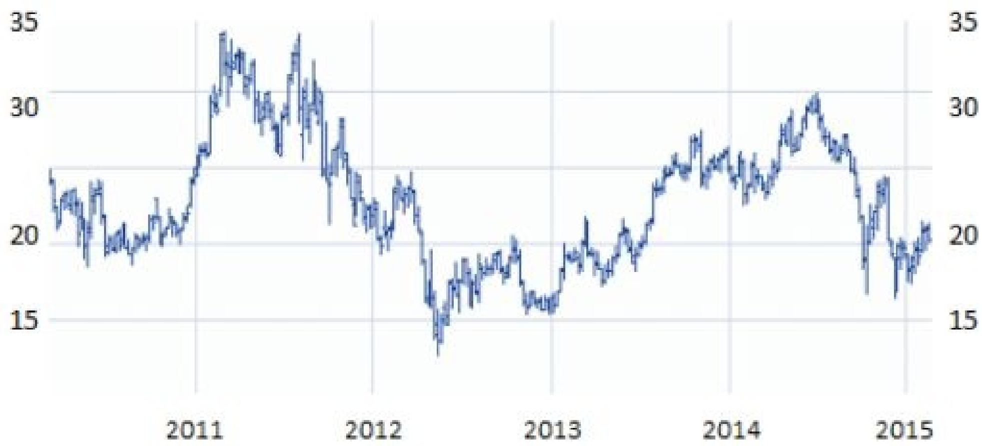


FIG 47: Chesapeake Energy (CHK) Chart, 2010-2015

With all the negativity and uncertainty surrounding the stock, I was certain I would see temporary losses in the portfolio as shares continued their decline. However, these lower prices would only render the shares a better buy. And that's exactly what happened.

I began accumulating shares below $20.00, and continued to purchase more as the stock continued to decline below $15.00 per share. My average price would end up being under $20.00 with a weighting of over 20% of the portfolio. As the stock rallied in the coming months, I was fortunate enough to sell some of the position in the lower 30s (near my estimate of intrinsic value).

As you can see, I could have simply stopped by just valuing the business based on its book value, or modeled its future like most of Wall Street with the continued decline of natural gas prices.

However, an investor must always keep asking "why?"

"Why is this occurring?"

"What's the overarching reasoning or justification behind this particular scenario or occurrence?"

And when you have those answers, you need to ascertain why the other side may (or may not) be wrong. This can be from any number of things, but the other side is usually wrong from psychological or analytical misjudgments (sometimes both).

It eventually led me to see that there was a mispricing here, and that there was a major disconnect between perception and reality -- between the stock price and the intrinsic value of the business.

The jury is still out on this one, especially as oil and natural gas hover near multi-year lows. I still believe Chesapeake Energy's better days lie ahead, and I look forward to what this company, and this country looks like as it approaches energy flexibility in the years and decades to follow.

Value Investing In Bull Markets…

"You never know who's swimming naked until the tide goes out."
Warren Buffett

In rising markets (bull markets) there are many winners. As a result, this type of environment makes it very difficult to distinguish between investment acumen and just plain luck.

It seems profitable investments are everywhere during these times. And if you aren't making the profitable investments, then someone else is. This can add to an investor's feelings of greed and envy, which can lead to mindset errors and biases.

Mistakes in these environments seem rare, and everything looks less risky. In fact, the riskiest businesses are paying off bigger than ever. This kind of risk-taking can even make the decisions seem justified in retrospect. Investing in riskier assets and having success just reinforces to the market participant that this behavior is ok.

Oddly enough, it's during these times when it's easy to let your standards down and join the folly that's all around you in the market. It may seem counterintuitive, however, during market euphoria and extended bull markets it could prove very prudent to raise cash levels if the risk does not support the reward. Stick to your philosophy of always demanding an appropriate margin of safety in every investment. Never yield.

Of course, as the market is rising, value investing can become out of favor. The media consistently seeks out popular stocks to parade on the television or online about why the stock is "doing well" on that particular day based on that one particular story. In a rising stock market, the environment is constantly paraded with momentum stocks which are not based on the fundamentals of the underlying business. This is a dangerous game to play.

Most of the time, the media uses confirmation bias to pick these stories based on how the stock is doing a particular day. It's best to ignore the noise on television and create your own opinion of businesses based on in-depth fundamental analysis.

*Indeed, when the stock market is making new highs, a value investor will face their toughest challenge yet: t*he decision whether to forego the margin of safety principle in hopes of participating in a broad stock market rally.

A value investing approach can be a handicap in such an environment, as out-of-favor value stocks tend to rise less than the public's favorite momentum stocks. This can also be a time when the value investor sells too early as the stock market makes its way from undervalued to overvalued territory.

The prudent thing to do in this environment is to remember what got you here. Was it the conservative, risk-averse approach to investing, or a momentum approach that helped you achieve your gains?

It's vitally important for investors NOT to participate in these stock market shenanigans that consistently reel people in. You are certain to encounter many of these extended bull market cycles in your lifetime. You must be patient and stick to your prudent risk-averse approach to investing that is encompassed in the 5M™ Mental Model. This is where so many investors go wrong.

Unfortunately, it’s happened before and it will most certainly happen again.

For example, Stanley Drunkenmiller gave us an incredible gift to learn from his mistakes without having to live through them ourselves.

Stanley Drunkenmiller was a protégé of George Soros. And he is considered to be a legendary investor in his own right as he compounded returns at ~30% annualized since 1986, before announcing in 2010 that he would return investor capital and create a family office for future investment.

Stanley’s lesson to us occurred during the famous rise of tech stocks through early 2000, when they ultimately crashed. To date, Stanley was one of the best performing hedge fund managers of all-time (still is). And he routinely warned his team of investing in these tech stock stocks that were backed by little more than hype and animal spirits.

However, a psychological shift was about to occur.

He couldn’t stand that everyone around him was making money while he stood on the sidelines. His emotion got the better of him and in an “emotional fit” bought the top of the market during market euphoria because he was tired of not participating in this raging bull market (regardless of the fundamentals).

With no regard of the fundamentals, he put billions in the tech market within hours of the top of the market. And it didn’t end well. When all the losses were tallied, in April 2000, the Quantum Fund was down 22% and the Quota Fund was down 32%.

Remember Stanley’s story when you think about abandoning your margin of safety principle during bull markets.

Stanley is one of the most intelligent and knowledgeable investors in the world today. And even he succumbed to the psychological pressures and biases around him. It’s just another example that we must always be aware of our biases and reasons for investment.

<u>Having a margin of safety can help to ensure you are constantly staying true to the value investing approach.</u>

Value Investing in Bear Markets…

"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."

Sir John Templeton

Of course the opposite of a rising market, is a declining market (bear market). Many do not know it at the time, but this is the most beneficial time to be a value investor. The bigger the decline, the better it is for us as value investors.

What?!?! What do you mean more decline the better…?

The decline in the stock market, and in individual stocks can create the margin of safety that we seek as long-term investors. Stock market declines weed out weak traders and investors from the market --- essentially creating a great entry point and runway for the long-term risk averse investor.

The majority of market participants are momentum seekers.

Momentum stocks usually have the highest expectation built into their stock prices. I like to say they are priced to perfection. As expectations are not met (i.e. missed earnings report), these securities can plunge. It is during market declines that momentum players, who were only concerned about what could go right, begin to panic when stocks decline (and only think about what's going wrong).

As the market continues to decline, the momentum players who bid up stocks due to excessive optimism, start to become panic stricken because of the declines in the stock portfolios. They start dumping stocks because they failed to know or understand the underlying business. This is a consequence of not knowing about the underlying business, and failing to adhere to the margin of safety concept.

Value investors don't have such unreasonable expectations when they purchase securities.

In fact, value investors usually invest in businesses that the market has no expectations of at all. They couldn't give them away if they wanted too. These are the moments that create opportunity for investors. It's that moment when the market prices these businesses as more dead, than alive (selling below liquidation value or extremely low multiples to cash flow).

A portfolio of value stocks can withstand significant pressure during general market declines. Your margin of safety increases the less the market is concerned with the underlying fundamentals of the business. The general market could expect continued decline and poor operating results; however securities purchased at depressed prices with a margin of safety are unlikely to fall further. Or at least they'll fall to levels where you have a low probability of permanent capital losses.

Securities that are purchased with little-to-no expectations can benefit immensely from a small change in market perception. Just a switch in focus from the negatives to positive realities of the business can result in increased security prices. The recovery in fundamentals is the added kicker to the change in perception. As the fundamentals recover, investors can benefit from the increased multiple attached to the security as well as from the actual recovery in fundamentals.

A market that declines in value is the ultimate test of your investment philosophy. It is vital that you adhere to a proven system of investing to keep you focused on the factors that matter most. It's during bear markets that great investors differentiate themselves from the mediocre investors and average returns. I, for one, become very excited during bear markets.

By always searching for that margin of safety, value investors can protect themselves from massive losses in any market environment, both increasing or decreasing markets.

Of course, if you can predict the future -- by all means participate fully in the market at all times. Ride the bull market to the top, and sell or sell-short at the market top. Crystal balls are an incredibly powerful tool. I myself have yet to come across one. More importantly, I have not met a single person that can predict the market cycles in a timely manner.

That is why I focus only on things that are IMPORTANT AND KNOWABLE.

Sure, knowing market cycles is important, but it is impossible to know it in a timely manner. The best you can do it always invest with a margin of safety. This will protect you over many market cycles.

Bull markets and bear markets will come and go throughout your lifetime. The only thing you can control is using a proven, repeatable system that always demands a margin of safety.

With this philosophy investors increase their chances of doing very well over time.

The Search for the Perfect Investment System…

"In business we often find that the winning system goes almost ridiculously far in maximizing and or minimizing one or a few variables."

Charlie Munger

What you see in the 5M™ Mental Model is not the perfect system or the perfect formula.

And I hate to tell you this --- but there is no such system or formula.

I don't live in Disney Land, and we don't buy bridges to 'nowhere' and neither should you.

Throughout financial history, individuals have greedily searched for the perfect investment formula. It's only normal that we, as humans, seek to find shortcuts to complex problems and situations. And investing can be a complex process.

Investment success that comes from a formula…

It sounds enticing doesn’t it? It’s unfortunate, but it doesn't exist.

The best an investor can do is create processes and methods, that help to form a rational system that can weed out the complex, and provide you with the most important factors in make great investing decisions.

5M™ is a set of mental models that helps to make a complex process simple (simple, not easy).

There are many investment formulas that are used by Wall Street, and other investment professionals that are purely backward looking:

Technical Analysis

Traders create algorithms and formulas using indicators that use past price movements to predict of future prices in the stock market.

Low Price-to-Earnings (P/E)

This is a simplistic, backward-looking formula. It’s a sound concept at first glance -- pay a low multiple of profits that the business produced. This is great, but this formula is still looking in the rear view mirror. The road you drive is in front of you. P/E metrics can move wildly at times and if you don't have an understanding of the future prospects of the business, it can leave you chasing your tail.

Usually, most of these low P/E stocks are priced in such a manner because the market is pricing in an earnings drop. If that happens, you could be left holding a high P/E stock now because earnings have dropped. The same goes for low price-to-book stocks that are over leveraged, and can lose assets very quickly.

Price-to-Book Ratio (P/B)

This is probably the least dangerous metric for finding potential ideas. I take it further, and only search for businesses below tangible book value (TBV). It will give you a larger margin of safety, as it doesn’t calculate intangible assets such as goodwill.

Although these fundamental and technical formulas can be a great place to look, they don’t constitute a perfect formula or a reason for investment.

You still need to have the mental models to conduct the proper analysis as to which businesses are the best compared to all the rest, and to ensure that you are buying them at a proper margin of safety to their intrinsic value.

So much effort has been expended trying to create the perfect formula, but no formula has been proven to work. There is no such formula that can accurately calculate the adaptive complexity that is the stock market all the time.

Even if a formula existed, it would cease to exist very quickly as everyone would rush to use it all at once. Essentially the arbitrage between the perfect formula and the returns it created in the stock market would be closed in an instant.

<u>This is why the 5M™ Mental Model, and value investing will continue to work over time---because it doesn't work all the time.</u>

There will be ups and downs, and there will be periods of underperformance. But if you follow this system of value investing (or any method of value investing, for that matter), you will increase the likelihood of having more ups then downs. And the certain periods of underperformance will set the stage for even more wealth creation in the future.

5M™ is a proven, repeatable and rational system to investment success--it’s not a formula. Investors are better served to focus their time and effort on systems and mental models that have proven to be successful, and repeatable in investing. 5M™ is such a system and mental model.

What a great investment looks like…

An important determinant of investment success is the probability of “risk.”

What do I mean by probability of risk?

As an investor, you will need to weed through, and ignore news headlines and stock prices.

An investor should only focus on the numbers, and future business characteristics of the potential investment. You will come across times during investment when you realize the “risk” of the potential investment is only associated with the market’s perception of it right now, and continued pain.

Just because a stock has fallen 50% does not make it riskier than a stock that is up 100%. <u>Ultimately, the 'risk' is the probability of permanent capital loss.</u>

With that said it makes sense to invest, and invest heavily, in higher probability investments. This will decrease your risk of permanent capital loss.

So what entails a higher probability investment?

Higher probability investments will have a number of characteristics including: sustainable competitive advantages, recurring revenue stream, high

FCF, high ROIC, reasonable debt load, great management, and hopefully trading under liquidation value.

Of course, this is the holy grail of investments, and it takes a reasonable amount of patience for these opportunities to present themselves.

My "Holy Grail" of Investing:

1) Easily explained sustainable competitive advantages
2) Low price to FCF (high FCF Yield) -- lots of FCF to the price paid
3) Trading below TBV or liquidation value
4) Capable owner oriented managers
5) Buying on a one-time or fixable event

If you encounter businesses with most (specifically all) of these characteristics, you must be willing to ignore what the market is telling you, and accumulate significant positions (if you have the opportunity).

Using a Range Of Values

Business valuation is not an exact science.

There is no hard number or exact process that produces the precise valuation of a business. Many investors relentlessly seek precise numbers in an imprecise world. You see this every day in the investment world when you hear specific price targets on stocks.

As humans we constantly seek certainty. Analysts and investment firms that sell securities know this --- and, unfortunately, they use this natural human need, to sell their ideas to the masses to collect commission fees. These price targets give the investor something to hold onto in a landscape that is constantly changing and evolving.

BOTTOM LINE: You need to give yourself a range of conservative estimates and valuations. After all, cash flow, earnings and book value are deductions by accountants that follow Generally Accepted Accounting Principles (GAAP). This strict set of principles and practices are designed to achieve conformity. They usually don't reveal the real financial value of the business. This is why value investing is so important.

Trying to ascertain the actual value of your home or your car is virtually impossible. So why would it be any easier for us to put a strict value on a complex and ever-changing business? There are too many dynamic variables in the marketplace to pinpoint an exact value.

Although an investor will never be able to pinpoint an exact value, he/she must regularly review estimates and probabilities, which have a great impact on the intrinsic value of a business. Estimates and probabilities will change over time, which means valuations will as well.

It's a futile endeavor to calculate an "exact" value of a business. If you try to do so, it can have significant psychological ramifications to your investment success, such as overconfidence and anchoring.

Precise valuation is the wrong way to approach value investing.

You want to make conservative estimates that give you a range of values, and then have your purchase price be so far beneath the range of values that you have an incredible margin of safety.

The confusion with security analysis and valuation analysis comes from the idea that most investors complicate the proficiency to make exact estimates with the proficiency to make accurate ones. Just because you make estimates based on past events, doesn't mean they will hold true in the future.

One must be able to weigh the actual probability of the business achieving those estimates. This is why it's so important to focus on a business's sustainable competitive advantages before making decisions based on highly dynamic discounted cash flow valuations. We will discuss this shortly.

The illusion of precision regarding discounted cash flows is both a blessing and a curse. As mentioned before, it can cause investors to become over-confident because their analysis on an overly complex spreadsheet said it would be worth a certain price. That means it has to be correct…right?

This can cause investors to stay anchored to that price, even as estimates and other variables are changing constantly around that business and its industry. Discounted cash flows using current growth rates can give investors a false sense of security if they do not use conservative estimates and focus on the sustainable competitive advantages of the business.

Discounted cash flow (DCF) models work great for securities, which are contractually obligated to distribute cash flows. For example, discounted cash flow calculations work more accurately with bonds, because of the higher probability of cash being distributed in a timely manner. Of course, DCF does not help you in figuring out the actuality of receiving those cash flows if business run into trouble.

Stocks, unlike bonds, have no contractual obligation to distribute cash flows. This makes it all the more difficult to value a business based on discounted cash flow, however, it must be done. It's very difficult to accurately calculate the intrinsic value of a business, let alone the partial ownership of a business.

DCF is a vital calculation of intrinsic value, however, it's not the only way. In a perfect world while using perfect estimates, DCF would be the ideal calculation. However, we live in an imperfect world. This is why we must incorporate probabilities of other conservative estimates in our DCF analysis.

Another way to value the intrinsic value of a business is calculating the liquidation value. Benjamin Graham frequently used a calculation called net-net working capital per share. It is also known as Net-Current Asset Value (NCAV) or net-net. It provides a quick estimate of a business's readily ascertainable liquidation value:

Net-Net = (Cash and short-term investments + (.75 * Accounts Receivable) + (.5 * inventory) – Total Liabilities) / Common Shares

The formula essentially states that cash and short term investments are worth 100% of its value, accounts receivable should be taken at 75% of stated value because the full value may not be collected, and inventories should be taken at 50% because it would need to be heavily discounted if the business closes.

Benjamin Graham would occasionally put together a basket of net-net (or NCAV) investments. He said the ideal time to buy net-nets is not when the markets are really cheap or really expensive though. And that's because when the overall market is cheap, the really good business will outperform and compound your return at a far greater pace than "cigar-butt" type investments, which are only good for one puff.

An example of this would be when Mohnish Pabrai purchased a basket of net-nets in 2010 in Japanese businesses. During this time, the Japanese market was at a multi-decade low. As the market rallied, behind unprecedented government stimulus, the net-nets didn't move a great deal as investors reached for the higher quality investments in the Japanese market. The Blue-Chip businesses in the Japanese market produced far superior returns compared to that of the lower quality net-nets.

There's a great site that has numerous screens including NCAV. Each business needs to be researched individually; however, it's a good place to start for potentially undervalued securities below liquidation value.

www.GrahamInvestor.com

It's interesting to note: This type of calculation by a legendary investor like Graham, goes to show you how difficult it is calculate a business's intrinsic value correctly.

Just look at the wide range of price targets for businesses that are tracked by Wall Street analysts. For example, let's take a look at Apple. Price estimates range between $60 to $150 from over 43 analysts and research firms. This is a highly profiled business, yet these analysts aren't even close to a general consensus with the best information provided to them.

So, how are we to achieve any better with limited, public information?

By not thinking that we can precisely pinpoint an intrinsic value of a business.

Imprecise value investing is more fun and rewarding!

If we approach valuation in a very conservative and rational manner, while waiting for the right pitch, we can give ourselves an advantage over our slower moving, incentive-driven and psychologically biased counterparts.

This is what makes a market, and it's also what allows for opportunity. There will always be differences of opinion in the valuation of a certain business. The main differences are in the form of estimates and time frame.

We can use this to our advantage (especially when most of Wall Street is guessing on quarterly earnings estimates). There would be no volatility in the market if there was no difference of opinion in the valuation or estimates of a business. If businesses could be valued perfectly, trading would grind to very slow speed.

As value investors, we always try to purchase a security at less than its actual value. However, the eventual sale of the security must be a value to the individual you are selling the security too. The difference in intrinsic value between buyers and sellers stems from differences of the future growth of the business, future growth of the economy, discount rates, interest rates or potential for a buyout (or if it's a trader, the price going higher or lower).

Thus, there will always be a range of values for perspective buyers in the marketplace. Having a range of values will help you to purchase with a margin of safety. The actual margin of safety could be anywhere below the range of values (or weighted average of those values).

For example, in 2014 this happened with Hillshire Brands (HSH) (a recent spin-off of Sara Lee). The company started the year trading at $33.38. Pilgrim's pride initiated the buyout by offering to buy Hillshire at $45.00 per share in cash. A week later Tyson Foods (TSN) splashed onto the scene with an all-cash offer of $50.00 per share. In a series of offers and counter-offers, Tyson Foods eventually completed the merger with Hillshire for $63 per share.

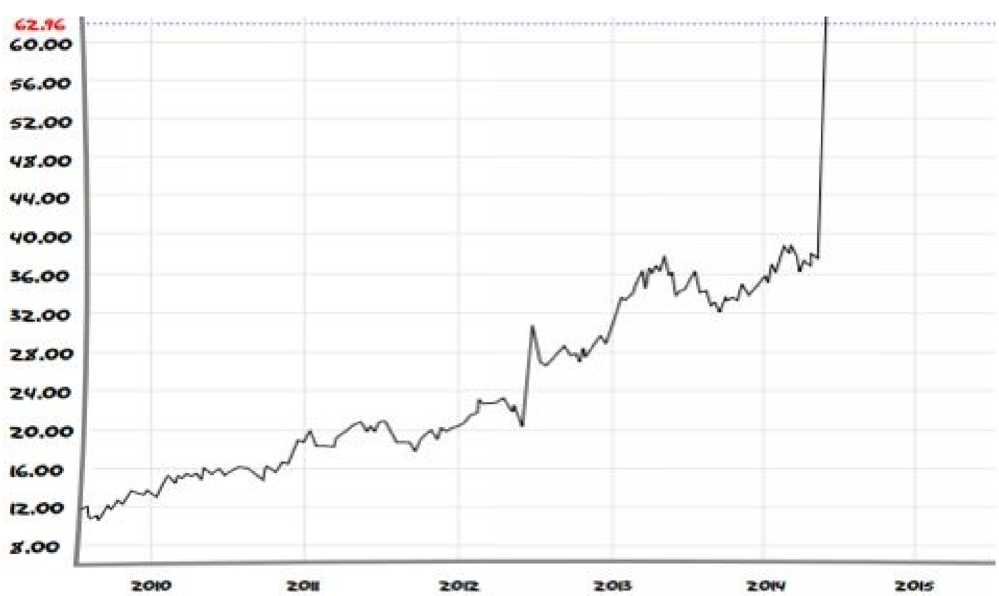


FIG 48: Hillshire Brands (HSH) Chart, 2010-2015

Tyson was willing to pay more for Hillshire because of the synergies associated with the deal and the fact that Hillshire has higher margin products which will eventually help the bottom-line to Tyson. There will ultimately be a difference of opinion on the final value of the business as one finalizes the acquisition, and the other watches from the sideline.

There are many methods for the valuation of a business, however, I have only found TWO that I find useful and logical. Even sum-of-the-parts analysis (SOTP) uses versions of these two methods, so we will focus on these two methods the most:

1) **Discounted Cash Flow (DCF)**
2) **Liquidation Value (LV)**

The first is an analysis of moat-type businesses, or businesses with sustainable competitive advantages. Ideally, these companies have been identified already as being able to produce free cash flow at reasonable-to-high rates of return into the foreseeable future. This analysis is *discounted cash flow (DCF)*, or net present value (NPV).

DCF is a projection of discounted future free cash flows to arrive at a present value. Essentially, we are trying to buy the discounted free cash flows of the business at a discount while allowing the compounding effects of that free cash flow to take over in the long run.

The second method is liquidation value. This method is mainly used for businesses in distress or bankruptcy. When using liquidation value, I expect that the business will no longer be an ongoing concern. I expect that the business will be broken-up and the pieces will be sold off. Of course, this gives me optionality if the business does not liquidate and recovers as an ongoing business.

There are weaknesses, as well as strengths, to each of these two methods, however neither one will provide correct values every time. And regrettably, better methods of valuation don't exist.

As a value investor that purchases below conservative estimates of intrinsic value, you have no choice but to use them on a regular basis. The trick is to use them in a very conservative manner.

Now that you know perfect precision with regards to valuation is not needed (nor realistic), I will show you how we can create a range of valuations using conservative estimates and probabilities. In the following two chapters, you will see why these two valuation strategies are the ONLY methods we use for valuation.

These methods and techniques will be all you need to accurately and conservatively value a business.

Isn’t it nice to know that you don’t have to be perfect to do very well over the long-term?

Let’s get started!

Conservative Discounted Cash Flow Valuation (DCF)

"The future is inherently unknown."
Unknown

Discounted Cash Flow (DCF) is the best method to use when valuing businesses with predictable free cash flows. The difficult part, of course, is finding businesses with predictable free cash flows.

To find these types of businesses, revisit the moat section in the MECOM method to ascertain how to identify a business with sustainable competitive advantages. Identifying sustainable competitive advantages is the only way a business will be able to produce any type of free cash flow over a sustained period of time.

DCF is one of the most precise types of analysis for valuation, however, future free cash flows are typically unclear. In addition, choosing a discount rate can be a subjective endeavor as well. For those two factors alone, DCF can be a tough, and inaccurate undertaking.

Don't worry. I have included links to all valuation methods to help in your journey. And we will go over a real life case study shortly.

As we know, capitalism is a brutal place for businesses. There are very few businesses that avoid their castles being attacked or burned to the ground over time. Even the few that are identified as moat-type businesses, will have a difficult time continually generating out-sized returns on capital because of increased competition.

The margin of safety in these types of businesses is usually non-existent because they are already identified as great companies, and the market bids them to extreme valuations. That's why it's so important to buy these types of businesses during events that cause mispricing. We discussed this previously in chapter 2.

Moat-type businesses have the distinct quality of compounding free cash flow over time, however, they're typically priced for perfection. In this particular case, the market is usually fairly efficient in identifying quality businesses. The problem usually stems not from finding high quality businesses, but in having the patience and discipline to purchase high quality businesses with a margin of safety.

No matter how great a business is, we have to purchase it at the right price in order for it to produce real investment return.

These high quality businesses are typically priced to perfection. So, if one little thing goes wrong with sentiment or the business, it can have a cascading effect on the stock price as well as other operating metrics. And this will have an effect on profits. Ultimately, this can bring about uncertain times. As an investor, you want to be comfortable around uncertainty. Then you'll have no trouble staying away from over-priced businesses.

Yes, some businesses have a higher probability of free cash flow than others. When you find these businesses put them on your watch-list and be patient. However, estimating free cash flow is usually quite arbitrary.

<u>Therefore, using a very wide range of high probability, conservative estimates is the only way to grasp the future cash flows of the business.</u>

Will DirecTV sell more subscription-based services next year? Probably.

Will they sell more in the coming years? More than likely.

However, the total amount is unknown.

What about capital expenditures for all the equipment and satellites?

What about non-payment from subscribers?

Pricing, demand sensitivity, competitors and even geopolitical factors can have an impact on profitability. There are many variables that go into factoring the future free cash flows of the business.

Most of Wall Street bases its investment decisions solely on growth. They are willing to pay incredible multiples on earnings and book value for that growth. As value investors, we understand that all great investing is value investing. We want growth too. However, we want to pay a reasonable price for it.

The higher the growth rate of the business, the higher the likelihood of continued free cash flow growth. However, there are far too many variables that confront investors that solely rely on growth for investment success:

1) Being able to consistently estimate growth in a business over a long period of time is virtually impossible.
2) Small changes in growth, up or down, can have a massive influence on the valuation of the business.
3) When you invest in growth companies, you are constantly involved in crowded investments and highly sophisticated investors. This can cause valuation levels to reach incredibly high limits that are

unsupported by the underlying fundamentals.

REMEMBER: The “Street” makes its money off of the marketplace being excited. When you trust the “Street” without doing your due diligence on a security and its valuation level, you are opening yourself up to unnecessary risk. Activity is how investment firms get paid.

Value investors will be left to watch from the sidelines when the game, and the casino, are working on all cylinders. The Street makes the majority of its money when the public is motivated more by greed than fear. The excitement and the incentive biases will cause market participants to overpay for many growth-related securities over the course of various cycles. It’s just how the game works.

A value investor’s performance will look crummy compared to the momentum seekers from time-to-time. However, I believe there are worse things in the world than someone making a little more money than you do. And I’m willing to wait as long as it takes for value to rear itself again. It’s during these times of exuberance, when you will feel the most pressure to abandon your discipline -- don’t do it.

You have two choices as a value investor: wait patiently or join the folly.

Unfortunately, many money managers with value philosophies are forced to choose the latter. Most do not have the institutional support which will allow them to deviate from the crowd for a period of time.

If they don’t play the relative performance game, they are at risk of losing their job. Personal preservation trumps everything else in this scenario. For those with job security and patience, opportunities will be everywhere when the enthusiasm and the jubilation diminishes, and panic and fear resurfaces.

Most money managers are trapped by their own institutional imperatives, and they don’t even know it. It’s given to the market that only the majority of the market will achieve average returns or worse. Therefore, there’s very little value added in the investment industry as a whole.

Now, don’t get me wrong, there are plenty of managers that provide value added services. However, on the whole, the industry doesn’t provide value. That’s the way a market works. It isn’t impossible, it’s just very difficult in the money management industry to provide value add to their customers.

The only way to outperform over the long run is to have the discipline to pick your spots, and have the conviction to invest heavily in high quality businesses that will compound your money over the long run.

In order to do this, you must have a contrarian streak at times. It’s not necessary all the time, but usually it’s where the greatest opportunity for outperformance lies. It’s beneficial to develop contrarian tendencies during periods of extreme euphoria and panic.

This means not being fully invested in the market at all times. This means holding cash and waiting patiently if that’s what it calls for during extreme bull markets and excitement. As far as how long I will wait? As long as it takes.

Another interesting result of growth businesses, is that when the growth is known, or expected, it’s usually already priced or discounted in the security. Anything less than that expected growth can have a disastrous effect on the stock price, and the current valuation if the business was priced for perfection. It doesn’t matter how great a business is, if you buy at the wrong price.

Additionally, when we talk about growth, we talk about it in overly simplistic terms. Saying a business is growing 7% doesn’t mean a great deal. What is growing? Revenues? Cash Flow?

And not only do you need to pinpoint where the growth is coming from, you also need to know the reason behind the growth. You need to know why they were able to achieve that growth, and the things that will cause that growth to continue.

Likewise, why are they able to grow in the first-place? What will cause it to continue? As you can see, these can be a very difficult questions to narrow down and answer.

So now you see there will always exist a permanent paradox: the future is not predictable, however, in order to calculate DCF we must predict the future.

So we’ve established that the future is ‘predictably, unpredictable.” We also know that, as humans, we are overly confident in our abilities to outperform the market. And we have that same overconfidence in our ability to predict the future.

So how do we handle calculating something that is inherently unpredictable and imprecise?

<u>The ONLY way is conservatively!</u>

All projections have a high probability of error. There are just too many variables. So using optimistic predictions puts an investor in a potentially dangerous situation. If an investor uses overly optimistic numbers, permanent losses are a real possibility, if the optimistic estimates don’t turn out to be correct.

However, using conservative estimates, and investing only at a significant discount from the valuation of those conservative estimates will serve investors extremely well over the long-term.

You will need three main inputs in order to calculate the valuation of the business for DCF purposes. Because we must be conservative about the inputs for DCF, I have included some “basic” guidelines below to keep you away from the potential for the ‘garbage in, garbage out’ analysis that is prevalent in this calculation. See below:

DCF Guidelines:

1. <u>Growth Rate</u> → Typically 3-5% -- (never more than 10-15%)
2. <u>Discount Rate</u> → At least 10-15% -- (higher if more uncertainty or better opportunities)
3. <u>Starting FCF</u> → Lowest Level of last 5 years / avg. of last 5 years / discounted number from current year or previous year

How Do We Choose The Growth Rate?

We have discussed this already, however it can’t be stressed enough.

<u>You must be very conservative with your estimates for growth.</u> If a company is growing 15% a year, all else equal, I would probably use a lower estimate. Probably 10% or lower depending on the business or industry. I think this gives a wider margin of safety, and it will also protect you from paying too high a price if the business does begin to slow.

How Do We Choose The Discount Rate?

The choice of discount rate is one that is not given adequate attention from investors. There seems to be much debate and confusion as to what the discount number should be. Some will use the Weighted Average Cost of Capital (WACC), and others will simply use the risk-free rate plus an arbitrary number.

Truth be told: A single accurate discount rate for future cash flows doesn’t exist.

There is no sure-fire way to choose one either. It depends on a variety of different things such as your inclination for future vs. present consumption, the risk profile in your portfolio, the actual risk or uncertainty of the potential investment and the opportunity cost of other opportunities.

For some reason, investors can oversimplify by only using one number for a variety of different investments with different levels of risk. Many just use 10% as a baseline discount rate for their valuation. However, there are other factors in helping us to decide an appropriate discount rate.

As a general rule, the higher the risk of future cash flow, the higher the discount rate. The lower the risk of future cash flow, the lower the discount rate. And that’s why our analysis of sustainable competitive advantages is key to being able to calculate DCF as accurately as possible.

Obviously, short-term U.S. Treasuries are used as the baseline for discount rates for near riskless securities. However, in low rate environments (which we are in right now) it can skew the appropriate discount rates and valuations. You should attempt to use the higher normalized interest rates as your baseline in finding an appropriate discount rate.

As you can imagine, the value of the business is influenced heavily by the discount rate you choose. And discount rates are ultimately influenced by interest rates. Obviously interest rates move on a regular basis. This brings us back to the question, “What is the right interest rate I should be using to help with choosing the discount rate?”

The bottom line is there is no “right” interest rate.

However, it doesn’t keep us from producing conservative estimates. This answer becomes more difficult during extreme moments of interest rate moves.

For instance, the world is at or close to 0% on 10-year notes right now. Is this sustainable over the long run? Probably not.

As a general rule, in a low rate environment, I will use a higher discount rate to protect against the eventual increase in interests rates from the economy growing quicker than anticipated or as a deterrent to inflation.

Just like other financial markets (equity/commodity), there is a cyclicality to interest rates. High rates will usually lead to low rates, and low rates will ultimately lead to high rates. It still doesn’t necessarily help in determining an appropriate discount rate but it helps some.

You will likely find abnormally high multiples in stocks during low interest rate environments. Of course, if you pay those multiples you better hope interest rates stay low for an extended period of time. It’s very important during low rate environments not to stray away from a conservative approach to investing.

Personally, I never calculate ANY business without at least an 8% discount rate. And that is for top-rated businesses like a Coca-Cola or Costco. Usually the discount rate I use ranges from 10-20%. Choosing a discount rate as conservatively as possible is critical. DCF can change considerably on small changes in discount rates, so always give yourself room for error.

How Do We Choose The Starting FCF Number?

In order to understand the probability of future cash flows, analysis of the underlying business must be performed. We have discussed this process in the Moat section of the MECOM™ Method earlier.

Once the underlying business is analyzed, and deemed to be a potential moat-type company, we can conservatively attempt to forecast FCF while assigning a conservative growth and discount rate.

Now we can calculate the DCF of the business in a very conservative manner.

As we know, valuation is not an exact science and DCF values will fluctuate (wildly at times). This is why I use DCF in a number of different scenarios. This gives me a range of values which helps me to conduct a sensitivity or stress test on potential investments.

I will usually give probabilities to 3-5 cash flow possibilities, and then I get the DCF values. Once I have the DCF values I multiply each value by the probability of the scenario actually occurring. I then sum up these numbers which gives me an idea of the "intrinsic value" over various likely scenarios.

Obviously, it can be very difficult to give probabilities to certain events which may not ever happen. Still, I see this as a prudent exercise and process to see how FCF, growth rates, discount rates and other scenarios can change the value of the business. If even the smallest changes to any of the inputs creates significant changes to the valuation, it could be a cause for concern.

To help explain the process further. Here is an example of an investment I made in Cisco Systems (CSCO) in mid-2011:

Cisco initially caught my attention because of its recurring revenue structure and large amounts of free cash flow. However, what really drew my interest was the market's perception of Cisco as an "old tech" company past its glory days. Bandwidth will continue to grow and will constantly be needed. Cisco was in a great position to reap the rewards because of its dominant market position, and its incredible capital allocation.

In valuing Cisco, let's start with the FCF number.

Cisco had Cash Flow from Operations of $10.2 billion in 2010. Capital expenditures for the year were $1 billion. The "back of the envelope" net free cash flow was about $9.2 billion.

From 2009 to 2011 FCF grew on average 15.6%. And from 2006 to 2011 FCF grew on average of 8.1%. Cisco grew FCF from $6.9 billion in 2005 to $9.2 billion in 2010. And in the process, Cisco has continuously grown earnings while achieving mid-teen returns in ROE and ROIC over the last 10 years. It also looks like Capex is increasing slightly, but has stayed relatively stable over that time.

Based on these growth numbers, and to be very conservative, I will come up with 3 growth scenarios for Cisco over the next 10 years:

Scenario #1

0% growth in FCF for years 1-3

5% growth in FCF for years 4-10

Scenario #2

10% growth in FCF for years 1-10

Scenario #3

15% growth in FCF for years 1-10

Furthermore, in keeping with our conservative estimates, instead of using the 2010 FCF figure of $9.2 billion to project 2011 FCF, I will be conservative, and use the FCF figure from 2009, 8.9 billion. Just to give us an even bigger margin of safety.

Why did I choose this number?

Because it was a year during extremely harsh conditions. And a number that I expected to be a cyclical low in earnings for the foreseeable future. As a result, it seemed like a very conservative number.

We will use a conservative discount rate of 10%, given the high quality, sustainable nature of the business.

And even after all the DCF, the business is still worth something at the end of the day (all else being equal). So we assume that the business is sold at the end of the year 10 at a conservative 10 times FCF plus any excess capital in the business. Cisco had $4.6 billion in cash at the end of 2010.

Look at the three scenarios below using these various assumptions, and see how I was able to arrive at a fairly conservative estimate of intrinsic value using a range of values.

Scenario #1 - 25% Probability

Year			Free Cash Flow (In millions)	Growth Rate of FCF	Discount Rate of FCF	Present Value of Future Cash Flow (In millions)
	Excess Cash					$ 4,500.00
1	2011		$ 8,853.00	0%	10%	$ 8,048.18
2	2012		$ 8,853.00	0%	10%	$ 7,316.53
3	2013		$ 8,853.00	0%	10%	$ 6,651.39
4	2014		$ 9,295.65	5%	10%	$ 6,349.05
5	2015		$ 9,760.43	5%	10%	$ 6,060.46
6	2016		$ 10,248.45	5%	10%	$ 5,784.99
7	2017		$ 10,760.88	5%	10%	$ 5,522.03
8	2018		$ 11,298.92	5%	10%	$ 5,271.03
9	2019		$ 11,863.87	5%	10%	$ 5,031.44
10	2020		$ 12,457.06	5%	10%	$ 4,802.74
10	2020	(Sale Price)	$ 124,570.60		10%	$ 48,027.36
	TOTAL					$ 65,337.84
	Shares Oustanding					5,848.00
					Intrinsic Value:	**$ 19.39**

FIG 49: CSCO Discounted Cash Flow, Scenario #1

Scenario #2 - 50% Probability

Year			Free Cash Flow (In millions)	Growth Rate of FCF	Discount Rate of FCF	Present Value of Future Cash Flow (In millions)
	Excess Cash					$ 4,500.00
1	2011		$ 8,853.00	10%	10%	$ 8,048.18
2	2012		$ 9,738.30	10%	10%	$ 8,048.18
3	2013		$ 10,712.13	10%	10%	$ 8,048.18
4	2014		$ 11,783.34	10%	10%	$ 8,048.18
5	2015		$ 12,961.68	10%	10%	$ 8,048.18
6	2016		$ 14,257.85	10%	10%	$ 8,048.18
7	2017		$ 15,683.63	10%	10%	$ 8,048.18
8	2018		$ 17,251.99	10%	10%	$ 8,048.18
9	2019		$ 18,977.19	10%	10%	$ 8,048.18
10	2020		$ 20,874.91	10%	10%	$ 8,048.18
10	2020	(Sale Price)	$ 208,749.11		10%	$ 80,481.82
	TOTAL					$ 165,463.64
	Shares Oustanding					5,848.00
					Intrinsic Value:	$ 28.29

FIG 50: CSCO Discounted Cash Flow, Scenario #2

Scenario #3 – 25% Probability

Year			Free Cash Flow (In millions)	Growth Rate of FCF	Discount Rate of FCF	Present Value of Future Cash Flow (In millions)
	Excess Cash					$ 4,500.00
1	2011		$ 8,853.00	15%	10%	$ 8,048.18
2	2012		$ 10,180.95	15%	10%	$ 8,414.01
3	2013		$ 11,708.09	15%	10%	$ 8,796.46
4	2014		$ 13,464.31	15%	10%	$ 9,196.30
5	2015		$ 15,483.95	15%	10%	$ 9,614.32
6	2016		$ 17,806.55	15%	10%	$ 10,051.33
7	2017		$ 20,477.53	15%	10%	$ 10,508.21
8	2018		$ 23,549.16	15%	10%	$ 10,985.86
9	2019		$ 27,081.53	15%	10%	$ 11,485.21
10	2020		$ 31,143.76	15%	10%	$ 12,007.27
10	2020	(Sale Price)	$ 311,437.59		10%	$ 120,072.67
	TOTAL					$ 223,679.82
	Shares Oustanding					5,848.00
					Intrinsic Value:	$ 38.25

FIG 51: CSCO Discounted Cash Flow, Scenario #3

So, the intrinsic values of Cisco range from \$19.39 to \$38.25. The stock was trading at under \$18 per share which gave a slight margin of safety to our low-line assumptions. However, I believed the most likely scenario is 10% growth in FCF in the foreseeable future, which is why I weighted scenario #2 at 50% probability.

This gives us a weighted intrinsic value of \$28.56 per share. With shares trading at less than \$18 per share, it seemed like a pretty good deal to me.

	Scenario	Probabilit	Outcome	Weighted Value
2009 FCF - No Growth Years 1-3, 5% Growth in Years 4-10 - 10% DR	1	25%	\$ 19.39	\$ 4.85
2009 FCF - 10% Growth - 10% DR	2	50%	\$ 28.29	\$ 14.15
2009 FCF - 15% Growth - 10% DR	3	25%	\$ 38.25	\$ 9.56
	Weighted Intrinsic Value:			\$ 28.56

FIG 52: CSCO Discounted Cash Flow, Weighted Intrinsic Value Calculation

In addition, the company issued its first dividend in 2011, so I expected there would be new capital allocated to Cisco from income investors and dividend funds that would need to purchase the stock in order to track their respective benchmarks, and to comply with their fund mandates. This would act as another catalyst to help Cisco reach its intrinsic value.

Also, calculating the reverse discounted cash flow showed that the market at the time was expecting only 4% growth from the business. Giving us further confirmation there was a difference between perception and reality.

I began to accumulate shares below $18.00 per share, which was more than 40% below the weighted intrinsic value of the business of $28.56 per share. And slightly below the low-line calculation of $19.39 per share.

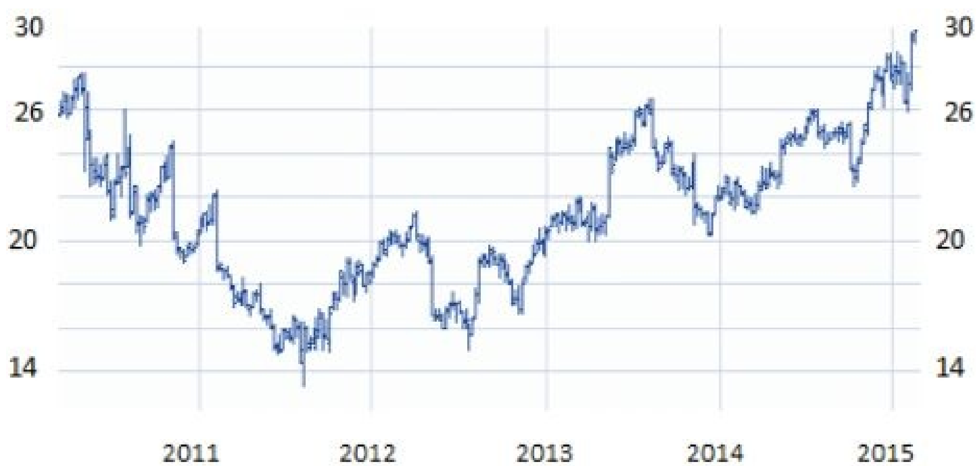


FIG 53: Cisco Systems (CSCO) Chart, 2010-2015

Once again, I suffered from premature accumulation as Cisco propelled right past my initial buy points. However, this was a quality business that I believed would be around another 10-20 years, and it still produced a significant amount of free cash flow during a very dire period. I was willing to pay up a little for a business with numerous competitive advantages, and trading at less than 10x free cash flow levels.

Disclosure: I currently hold no positions in Cisco (CSCO) at the time of writing.

Conservative Liquidation Valuation

For some odd reason, the vast majority of individuals have a very difficult time grasping the concept of liquidation value, and buying a security at a significant discount to that liquidation value.

It mainly stems from the perception of where the business is currently.

If a business is trading below its liquidation value, it’s usually because the business is suffering or has failed to meet the expectations of Wall Street. Thus, the business is usually loathed among the investment community for a myriad of different reasons.

The very fact that people dislike businesses, even when a business is trading well below its liquidation value should intrigue you as an investor. This type of herd mentality toward hated stocks keeps individuals from making contrarian investments, even though the underlying fundamentals may paint a different picture.

Basically, these individuals are saying they know it’s trading well below its intrinsic value. However, they still wouldn’t touch it with a 10 foot pole. Personally, I love these kinds of situations. This is the perfect example of finding a situation where, for some reason, there is a great difference between perception and reality.

Liquidation value is the conservative estimate of a business’s worth by only using the tangible assets of the business. Cash flows and intangible assets are not calculated in this type of analysis.

As you can see, this signals that the business is worth more dead, than alive. The liquidation value usually constitutes the lowest value in the sale of the business. So a stock that’s selling significantly below the conservative liquidation value of the business, usually signals the potential for an interesting risk-averse investment.

When I say a business is trading below its liquidation value, I’m not saying it’s actually going through the liquidation process. It’s a hypothetical valuation of the business. A business that’s trading readily below its liquidation value merely illustrates to an investor that there is a deep disconnect between the underlying business and the stock market. These are the moments we look for as value investors.

And this doesn't mean the stock will trade at its liquidation value tomorrow or next week or next month (…or even next year). Anything could happen to the stock price at any given moment. A business that is trading below its liquidation value points out the perception that the business is worth more dead than alive. And that signals potential opportunity.

If you believe the business has ongoing business characteristics, you may be onto a tremendous investment opportunity with very little downside risk.

Liquidation value is usually the worst case scenario analysis of the business. Typically this analysis is conducted on businesses that are no longer a going concern.

So, <u>if you're able to find ongoing businesses that are trading below liquidation value you may have a tremendous opportunity in front of you.</u>

So how do investors value the assets in liquidation analysis…

During liquidation analysis you try to derive a conservative value of each asset component. During this process assets will be conservatively discounted, and debt will usually be valued face value.

As a general rule, a forced sale will yield a lower value of the assets (fire sale). An orderly sale of the assets usually leads to higher realization of value of the assets.

To be conservative in our analysis of liquidation value, we will use mid-line estimates of discounts in our analysis of the assets. It is better to be conservative with these values. You can always adjust upwards if you see fit. This depends on the quality of the assets, as well as whether liquidation occurs in an orderly or fire sale manner. Every situation is different, and with that comes a different probability of certain outcomes.

Here is an example of the mid-line discounts I give to each asset in a fire sale situation:

Cash ------------------------- 95%
Marketable Securities ---- 90%
Receivables ---------------- 75%
Inventory------------------- 25%
PP&E-------------------------50%
** Similar to Benjamin Graham's Suggestion in Security Analysis*

Cash, as in the money in your wallet, is valued at 95%. I just have a difficult time giving anything 100% value, so I discount it. I like having as big a margin of safety as possible.

Marketable Securities, or investment securities, should be valued at their current market prices. I like to discount these as well to account for market volatility and transaction costs.

Receivables should be discounted more to account for delinquent or unrecoverable receivables. Sometimes this is already accounted for in the receivables number, so check to make sure in the 10-K.

Inventory will probably be the most heavily discounted asset on the balance sheet. Inventory is usually a lower priced item compared to PP&E, and can be moved quickly, sold and turned into cash. Of course this is only contingent on whether the asset is still be relevant or something that consumers still want to consume.

Property, Plant & Equipment (PP&E) will be heavily discounted as well. However, this depends on the quality of the assets, and whether there are hidden assets imbedded within this asset. The quality of the asset really depends on its ability to generate cash flow. It also depends on percentage of PP&E is property, plant or equipment. Hidden assets are usually found within property or marketable securities, but plant could be a hidden asset as well.

It has been my experience that PP&E is ultimately valued or liquidated at well above the 50% discount. I still like to have the margin of safety, so I will keep at 50% to be conservative. Again, this depends on the quality of the asset and when the PP&E was purchased.

With virtually every discounted asset, the discount depends on the type of customer, type and nature of the business and whether it’s an ongoing business or not.

REMEMBER: In a fire sale liquidation scenario, you will need to discount these numbers even more. In an orderly liquidation scenario, values will be higher and closer to actual tangible book value.

So how do investors value the debt in liquidation analysis…

Debt is a little easier to calculate, however you must be aware of hidden off-balance sheet issues as well. These include underfunded pensions, leases, lawsuits or other contingent liabilities. We discussed this previously in the obligations section.

Adjusted Liquidation Value Calculation:

(Discounted Assets - Adjusted Liabilities) / Shares Outstanding
= Liquidation Value

There is also a short-cut to liquidation value that was given to us by the father of value investing, Benjamin Graham. Net-nets or net current asset value (NCAV) is when you calculate the conservative liquidation value of the business by taking only current assets and subtracting ALL liabilities. You would take this number, and divide by the shares outstanding to arrive at a back of the envelope liquidation value.

(Only Current Assets – All Total Liabilities) / Shares Outstanding

As you can see, PP&E and other long-term assets aren’t even included in this calculation. Graham recommended buying at 66% below the NCAV number. He proclaimed you could know very little about the underlying business, and still do very well over time by investing in these types of businesses.

In fact, many that still invest in these types of business have consistently produced over 25% compounded for their portfolios. I know of a few myself, but these opportunities don't come around too often. When they do, you need to pounce quickly.

When you buy below NCAV, you are shielding yourself by using only current assets as your estimate of liquidation value. This is true whether the business is considered ongoing or not. However, one thing we must be very cautious of is the rate of cash burn or overall deterioration of the underlying business.

Business losses can quickly take out current assets, so we must always gauge the current operating environment of the underlying business. And we must also be on the lookout for off-balance sheet liabilities as well.

If current assets are not over valued or deteriorating rapidly, a business could theoretically liquidate the entire business to take care of all liabilities and still leave some left over for investors. There is obviously a MASSIVE divergence between perception and reality.

As I have stated before, bankruptcy and liquidation is usually associated with negative connotations of failure from a public and corporate perspective. As an investor, this couldn't be further from the truth (depending on when you invest).

And therein lies the potential opportunity. Most people run from adversity and failure and distress. Most will run from the fires--we will walk slowly towards it looking for opportunity.

Liquidation of a public business makes for an interesting case study in how the stock market is not always efficient. It is one of the few instances when the concept and philosophy of value investing is revealed to the market in a very powerful way.

Is the stock market really a gigantic virtual casino with electronic stocks to be traded back and forth in nano-seconds? Or are these electronic stocks part of a real business?

The actual liquidation of a business settles this debate once and for all.

Investors actually receive proceeds from the sale of the business. And if an investor purchases prudently, he/she will receive a profit if they purchase shares below the final liquidation value. This is the very essence of why Graham called the stock market a "weighing machine" over time.

The liquidation of a distressed business acts as the midline of a business's intrinsic value. The stock will become undervalued or overvalued on any given day. Over time the stock price will hover around its intrinsic value.

BOTTOM LINE: <u>If you consistently purchase stocks of businesses trading below liquidation value, you give yourself an incredible margin of safety with very little risk of permanent loss.</u>

If you add to that scenario, with a business producing (or likely to produce) free cash flow in a turnaround scenario, you have very powerful forces behind you as you pick up a left for dead company on the cheap that's now producing free cash flow.

Ultimately, the stock market will re-price the business and its future. This kind of price discovery can be quite powerful in the future stock price of a distressed business.

You want to always watch these distressed types of businesses that start producing free cash flow. Especially when their efficiency metrics start to take a turn for the better. It could be a sign of potential turnaround of the business. And what follows suit soon after will be the re-pricing of the business. You want to recognize this before the re-pricing takes place.

To help explain the process further. Here is an example of an investment I made in Bassett Furniture (BSET) after screening for businesses trading below tangible book value.

Bassett is a vertically integrated furniture company (imports, manufactures, wholesales and distributes). It went through some difficult times after the housing crash. However, it seemed that operating and efficiency metrics were stabilizing and improving.

At the time, Bassett was trading at less than $5 per share. What intrigued us the most was the fact that it was trading well below its tangible book value of ~$9.00. Of course we wanted to dig in further to see if this was a true and stable liquidation value for the business. And we also wanted to discount the assets on the balance sheet to see if we could arrive at an additional margin of safety for potential investment. See the figure below for our analysis (fig. 54).

1/14/2011

Current Price	TBV	Adj Net-Net Value	Margin of Safety
$4.30	$ 9.25	$ 4.14	0%

Figures in Millions except per share values	Book Value	Book Value Discount	Adj. Net-Net Value
Cash & Equivalents	$ 11.10	100%	
Marketable Securities	$ -		$ 11.10
Receivables	$ 31.60	75%	$ 23.70
Inventories	$ 41.80	50%	$ 20.90
Other Current Assets	$ 7.00	50%	$ 3.50
Current Assets - Total	$ 91.50		
Tangible Assets (PP&E)	$ 46.30	75%	$ 34.73
Other Long-Term Assets	$ 59.60	75%	$ 44.70
Total Liabilities	$ 91.00		$ 91.00
Shares Outstanding	11.5		11.5

	Total ($M)	Per Share
Total Current Assets	$ 91.50	$ 7.96
Market Cap & Share Price	$ 49.45	$ 4.30
Tangible Book Value	$ 106.40	$ 9.25
Adjusted Net-Net	$ 47.63	$ 4.14
Discount to Adjusted Net-Net		0%

NOTES:

- No Pension related obligations
- No Lease related obligations

FIG 54: Bassest Furniture (BSET) Liquidation Analysis

This analysis showed little-to-no margin of safety with the adjusted liquidation value of the business. However, this was also a business trading at less than 50% of its tangible book value. And not only that -- It was also beginning to produce FCF, and seemed to have no threat of bankruptcy in the immediate future (operations seemed to be turning around).

As you can see, there was a major disconnect in this stock.

To our surprise it got even better.

Here comes the best part -- the element that ultimately swayed us to invest in the business:

Bassett had an additional margin of safety in the form of hidden assets on its balance sheet. We were fairly confident that PP&E on the balance sheet was being carried at far less than their actual value. We still discounted these assets at 75% to their book value (just to be safe).

If you remember, hidden assets can be difficult to find. However, you will find them from time to time. These hidden assets get even more interesting when businesses are trading below their liquidation values because the hidden assets can act as catalysts in a spin-off or sale of the asset.

These hidden assets offer an added margin of safety that's not wildly known to the public. This can provide a nice upside surprise to those aware of the hidden assets.

This was the case with Bassett. They owned almost 50% of a sizable 3.5 million square foot furniture showroom that was actually being carried on the books as a $7 million liability (and that's why you don't always trust GAAP accounting).

Well, Bassett eventually sold this asset realizing over $70 million in pre-tax proceeds from the sale, which was more than the entire current market cap at the time. Obviously, there was a major disconnect and mispricing in this stock.

After the announcement in early 2011, shares shot up over 50% in a couple of days' time. And over 100% in the ensuing months, as the market caught on to the value of Bassett. After various special dividends to shareholders and improvement in operations, shares are trading over $20 per share (not including dividends).

FIG 55: Bassest Furniture (BSET) Liquidation Analysis

Full Disclosure: No longer hold any positions as it has surpassed our estimates of intrinsic value.

As you can see from the previous examples, value investing is a simple concept: purchase something for less than it's worth.

However, we know through experience that the implementation of value investing is easier said than done. That's why it is imperative for investors to have a system or process to keep them focused.

I'm not an overly sophisticated or analytical person, and 5M™ is none of these things. We're not trying to employ rapid trading algorithms and models. We adhere to a simple, easy to remember value investing system. That's it.

The most difficult part of value investing is your patience and your discipline. And even if you have endless patience to wait for the right investment and discipline to stay away from unattractive situations, you still need to make the right judgments of when to make the right investment.

Investors should ALWAYS make decisions based on what they would pay for the whole business. Don't pay what others are willing to pay or would pay for popular stocks. Be honest with yourself, and always try to ask yourself, "what would I really pay for this business?"

These two valuation models should be used as your main methods for valuing business. However, any one model or scenario, in-and-of-itself, does not mean it constitutes the Intrinsic Value of the business. Using a range of values will help you in ascertaining a conservative and appropriate margin of safety.

In this section, you learned the art of valuation, how to use a range of valuations in your approach, how to use DCF to value a business conservatively, and how to use Liquidation Value to value a business conservatively.

So at this point you have Mastery of The Market, Your Mindset, Your Morals, The MECOM™ METHOD, and Your Margin of Safety.

You now have a Mastery of Investing!

The point of this book is to condense the most important elements to investing success, based on years of real-world experience of managing money, as well as research and interviews of the top investing minds of today.

An understanding and mastery of this information puts you easily in the top 2% of other investors in the marketplace. Congratulations! I doesn't end here though. Keep learning. Keep trying to better yourself and others and…

Stay Within the 5M™ Mental Model:

1) Know Your Competition,
2) Stay In The Proper Mindset,

3) Use Long-Term Investing Philosophies,
4) Use A Simple Method To Business Analysis, and
5) Invest With A Margin Of Safety

And you will be surprised how quickly your wealth will compound over time. I look forward to hearing about your journey in the years to come. And I thank you for allowing me to be part of your journey.

Now let’s put it all together!

PUTTING IT ALL TOGETHER

"An investment in knowledge pays the best interest"
Ben Franklin

The best investing tool you have is your BRAIN.

Learn as much as you can. Learn to interpret 5M™. And learn to interpret financial statements in your own way. This will allow you to have conviction in your own decision making process. You will know what feels right and what feels wrong.

Consider the opinions of others, but never act on them without confirming the information on your own. Investing isn’t easy (anything in life worth attaining rarely is).

However, it can be simple if you follow a system. The mental models and the system that you use and develop will compound with knowledge over time. It’s the ultimate snowball effect.

Let your instincts and your brain take over. Don’t trust suggestions. Always look for the truth in the numbers. Learning to be self-sufficient with your investment decisions will give you a huge advantage over the other 99% of individuals in the marketplace.

As far as investing goes, NOTHING will pay off more than educating yourself. Before any investment decision is made you must do the necessary research and analysis. 5M™ guides you through just that.

Be happy and excited about investing, but NEVER become complacent. Always be prepared to sell during high, exuberant markets, and buy in low, depressed markets.

There will definitely be times when you will have to step out of your comfort zone -- that's normal.

It's called investing.

You will need to do this over the long term to realize significant gains and distance yourself from the rest of the competition. It’s vital that you know the boundaries of you comfort zone. So practice stepping outside of it every once in a while in small doses.

First and foremost, you need to know yourself before ever stepping on the field of the investment world.

Not many people can handle being contrarian. It takes a lot of knowledge, experience, and guts to jump into an investment when you know others are selling. The same goes for selling when you know others are buying momentum stocks at ridiculous valuation levels.

The best system in the world can't help you if you don’t have the discipline to see it through to the end. And the same goes for investing. If you don’t have the guts to see it through based on your original investment thesis, the best investment idea could turn disasterous.

Can you *really* see it through to the end?

There will always be recessions, depressions, and stock market declines. Always be ready for them: this is usually the best time to invest.

When declines in the stock market are an everyday occurrence, it’s critical that you stay true to the 5M™ Mental Model of value investing (or any rational system for that matter).

You must stay the course! There is a cyclical nature to most things in this world --- the economy and financial markets are no exception. There will always be ebbs and flows. Expect it. Welcome it. This will always put you in the right frame of mind to take advantage of the opportunities that others create from irrationality or fear.

The great part is --- You’ll never be alone.

You have this system, and this community to always fall back on when times are tough. This is something I wish I had in my early days as an investor. And I treasure it even more now as a seasoned investor.

Being part of the Endless Rise Investor group is like being part of one big investing mastermind group. It can keep you focused on your long-term goals of compounding your wealth without all the outside noise.

Before I send you on your investment journey, I want to thank you for taking the time to invest in YOURSELF. Not many people have the discipline and courage to learn more and continue to grow.

Wealth is something we all seek as individuals. And it comes in many forms.

But how is it achieved?

It starts with having something you’re passionate about. Invest in yourself by what ever means necessary to be the best at what you do. When you are on that path, find a way to use this to produce income-generating endeavors and invest along the way. The way to wealth creation really is that simple.

"It's not how much money you make, but how much money you keep, how hard it works for you, and how many generations you keep it for."
Robert Kiyosaki

I have a simple formula for investment success:

Work passionately while always learning + Pay off high interest rate debt and keep debt at low rates + Monthly Savings + Risk Averse Investing = Investment Success

I know it's a simple formula -- BUT it's a simple concept.

And there's no need to complicate simple concepts. The problem arises when individuals try to gain wealth too fast. Getting rich or wealthy slowly never bothered me too much.

Financial peace isn't about acquiring more stuff in rapid succession. Using a simple system with simple processes and methods helps to get rid of that mindset while deflecting the clutter.

Learn to live a great life with less complication. It's all about living on less than you make and saving the rest in a risk averse manner. By investing and being thrifty in your spending on unnecessary things, you can ensure that you will have enough money for your retirement, your family, your dream car or dream boat.

Once again, this doesn't happen overnight. If you want to gamble, then you should go to Vegas. Value investing requires work and patience. However, the gains you will see over time will more than make you a believer.

You need to get your feet wet and have confidence in your investments on your watchlist. Once you get comfortable you can make adjustments to your portfolio to make better and bigger investment decisions over time.

If you follow this system, you do the research, you compile a watch-list, and you await patiently while keeping your temperament in check, your chances of investment success increase dramatically.

In fact, they continue to compound as you learn more and more about investing and the businesses that interest you. And 5M™, and its components (as well as the community), will always be here for you to reference or fall back on for confirmation or insight.

My Mentor

You've heard my journey, my story, my dreams, my process and my philosophies, my vision and my passion for the future of investing, and the future of YOUR investing journey.

I always had a passion for helping people be as great as they want to be. And it’s no different with investing. However seemingly young I was for the financial industry, I’ve always wanted to help my junior traders, analysts, and colleagues invest better. And I want to pass on this mentorship and coaching to others. It is a passion that drives me, and it’s something I feel I need to give back to others because I have seen and felt the impact of coaching and mentorship firsthand.

For far too many nights, I remember laying in my tiny apartment wondering how I was ever going to be successful at investing. Would I ever have a real understanding of these businesses? Would I ever be able to grasp investing?

Then one day I saw a man on TV talking about value investing. His rhetoric and aptitude for investing was beyond anything I had heard before. He was passionate about investing and seemed to speak my language. I thought to myself, “I want to learn everything that this guy knows.”

His name was Whitney Tilson, Portfolio Manager of Kase Capital (formerly T2 Parners).

Although I am usually quite skeptical of personalities on television or the internet, this guy truly comes from the heart. He is an incredible investor and educator, but he’s an even better person. And I saw it first-hand.

It wasn’t what he was saying; it was how he was helping people with investing --- And helping them have better lives as a result. I wanted to do the same thing.

That night I convinced the Investment Firm I was working for at the time to give me time off to attend the Value Investing Congress, and the *advanced value investing class* with Whitney. I was in my early 20’s and didn’t have a great deal of money at the time as a young analyst, so I told them all I needed was the conference ticket and plane ticket, and I would find a place to stay.

They agreed, and I was able to see Whitney in person. I got to ask him all kinds of questions, which helped clear things up. It helped me focus on the components that mattered most to investing success.

The advanced session walked through each investment they had made, and why certain decisions were executed. It opened my eyes to investing. More importantly, it made me realize that I wanted to do this for other people.

I can say without any hesitation, that this one seminar changed my life, and put me on the path to value investing. It’s what I wanted to do the rest of my life. I just didn’t know exactly how to get there at the time.

Throughout the years that followed, I listened to and read messages from the greats --- from Benjamin Graham and Warren Buffett, to Peter Lynch and

Charlie Munger, to Seth Klarman to Leon Cooperman to Mohnish Pabrai. I did anything I could to improve my investing process and philosophy. Because of these incredible human beings, I was able to gain the wisdom to be able to show others how to invest. And I will be forever grateful.

These investors have helped so many people throughout the world to better understand investing. So I suppose it’s a common story.

When I was creating the 5M™ Mental Model in mid-2009, it was initially made to help me and educate potential investors in my fund about my process of selecting and investing in stocks. It pains me to say it, but I initially created a system like this for selfish reasons.

As I finalized the process, I asked friends and family to look at it and let me know what they thought. Would they invest in the fund? They responded resoundingly with, "Not only would I invest in the fund, but I learned more about investing through the content and material than I have in my entire life."

They opened my eyes to the possibilities that were there to help educate people about investing. They said, "You should offer this to everyone, not just potential fund investors." I thought about that for a few days and decided to open it up to the masses. It was at this point when I thought everyone should have this system and the mental models associated with it.

Ultimately, the potential to touch millions of people's lives and impact them and their families in a positive way was too much to pass up. After years of working on this book and putting 5M™ together, I quit my cush job at the hedge fund, and decided to create *Value Investor Confidential* and this book you are reading today.

It was quite difficult to get off the ground with this project, but it was worth it in the end. Seeing people's lives changed forever is worth ALL of the trials and tribulations it took to get here.

BOTTOM LINE: Our society has discounted the value of mentorship and proven processes (or systems).

I would love to be a mentor or coach to you, like Whitney was to me. Send me your stories of the 5M™ Mental Model and MECOM™ Method in action.

I look forward to hearing about your journey!

The Time is Now--Action is required

"How many millionaires do you know who have become wealthy by investing in savings accounts? I rest my case.y

Robert G. Allen

The earlier you get started investing, the better chance you have of compounding wealth over time.

If you follow these simple recipes: 5M™ and MECOM™ specifically, it will be VERY difficult not to make money over time. People have made unncessary mistakes because they were in a rush to be rich too quickly. You don't need to be in a hurry to be wealthy. It can happen faster than you think with value investing.

There are many out there that equate value investing to watching grass grow. My response is, “Yes, but have you ever seen how fast grass grows in a month without having to watch it like a hawk?”

Usually an awkward silence ensues. To which I reply with a smile, “Exactly.”

The beautiful part of investing long term is that you don't have to be brilliant to be successful. You just have to keep learning, and use simple, rational systems over a long period of time.

These are not new concepts; nor are they revolutionary ideas.

My hope is the way the ideas and concepts are organized and framed in the 5M™ Mental Model will be REVOLUTIONARY.

It’s designed to help you learn, visualize and retain the information more effectively and efficiently so you can make the best decision possible. I don’t know of anyone that tries to teach value investing with these mnemonic memory triggers. And you can use it for any business!

I do have an opinion about who succeeds at wealth accumulation and who doesn't. It’s the person that has a core set of concepts and processes that allows him/her to focus and keep going. That will be YOU.

There will always be bumps in the road. There may be tweaks here and there to the system. But over time, the core 5M™ Mental Model of value investing will serve YOU well in making successful investment decisions.

It has nothing to do with how attractive you are. Or how smart you are. Or how many connections you have.

The best business people, and the best investors stick with a system and philosophy, and they keep moving forward. Perseverance and a willingness to learn proven processes is the secret to success in the world.

I want to leave you with one last thing before you go: It’s VITAL that you take action regarding your future wealth accumulation and creation.

Whether you use 5M™ or use the MECOM™ Method or buy a low cost fund that tracks the S&P or use another system; if you look back a month from now, and you haven’t tried to understand your retirement situation or your investments, you will look back having done nothing. And that’s time you’ll never get back.

You’ll be in the same place you were before reading this book.

That’s an important concept: nothing gets done in life without taking that first step. Nothing will get done in growing your money if you don't take that first step to invest your money soundly. I look forward to taking that step together.

5M™ is aimed at transforming the thought process and quality of life of people that invest in the stock market. It outlines the investment methods, strategies and tactics that are geared toward producing the best results over the long run. If the system and methods within this book are followed in a disciplined manner, prosperity and financial success won’t be too far behind.

5M™ is a product of some 10 years of experience using every investment and trading strategy you could think of in the stock market. I’m not a salesperson, I am an investor (not that I have anything against salespeople). The methods, strategies and tactics set forth in 5M™ will bring any individual or business into the higher echelon of investors.

The methods under 5M™ are designed to describe the primary factors that are absolutely necessary to achieve investment success!

How much would it cost YOU not to take action to increase your return on investment? How much would it cost to have a process to help weed through the voluminous amount of data and noise in the world today?

I know the answer to this. For me, it’s priceless to have a system and set of mental models like this I can use over and over again for the rest of my life. I know because it’s worked for me and many others. I value my time, and I value my money and how it’s being invested. My hope is that you use this system like I did to make your investment journey as simple as possible with great results.

Make the decision now and change your life forever.

If you don't want to do it for yourself, then do it for your family and your future generations.

There is so much abundance and wealth and opportunity out there in the world.

The future belongs to those who are positive and keep learning to better themselves and others.

Go get it!

Let’s see what’s next!

WHAT'S NEXT

"The nice thing about investing in stocks is that, over time, equities are going to do well. American business is going to do well. America is going to do well. So you have the tide with you."
Warren Buffett

I hope you enjoyed going through our 5M™ Mental Model, and learning about the methods and thought processes that makes it so special and why they've been so effective for us.

My only request is that you go out and actually use this stuff to help you invest better.

Over time, I have learned that great investors tend to focus on the process more than the actual outcome.

Because if you have a simple, proven, repeatable system with relevant mental models, the results will ultimately take care of themselves. Having this 5M™ Mental Model with the MECOM™ Method will allow you to focus on the components that matter most to an investor's success.

If you loved the book and the thought process behind value investing, or even if you still don't have the time to put in the work to use the System and the Templates, you'll love what we have in store for you.

REMEMBER: You have LIFETIME access to our investment idea engine:

https://GuruInvestorEdge.com/LifetimeAccess

Full Disclosure: I don't know how long this offer will be available. Unfortunately, I take a great deal of financial risk by offering lifetime access to an ongoing publication. *The only reason I am offering this right now is because I truly believe it will help tremendously to your investing success well into the future.* And I want to reward action takers.

However, at some point this offer will expire. Essentially, You make a miniscule investment today and then you get ALL the ideas for free for the Lifetime of the publication. It's an incredible offer and its only available to our readers for a limited time.

So Feel Free To Check It Out.

You'll find loads of great investment ideas. You can use them to help you on your path to investment success.

Remember the more you invest now, and get to know the underlying businesses and the stock market, the better you'll be at investing long-term.

Keep in mind that it takes more than just reading this book or talking about these concepts at holiday parties. Follow these mental models, and focus on them long enough to create everlasting habits and positive feedback loops as you compound your knowledge of investing and the world around you.

Thanks again for reading this book. I'm excited to hear about your journey and the results you have achieved with everything inside of this book. Make sure you share your success story once you put all of it into action.

Best Wishes,

J. Lukas Neely
EndlessRiseInvestor.com, CEO
GuruInvestorEdge.com, Co-Editor
ValueInvestorConfidential.com, Co-Editor

WILL YOU DO ME A SOLID?

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If someone you care about is struggling with investing or growing their wealth, please send him or her a copy of this book. Whether you gift it to them on Amazon or email a copy of the PDF makes no difference to me.

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Your Journey Awaits. Rise On!

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I would like to thank all my friends and family for all their support throughout this process: Brandon Consolvo, Andrew Luscz, Conn Davis, Aaron Smith, Jeremy and Stephanie Parten, Dan Davis, Jake Neely, Mike and Jeneane Neely, David and Debbie Loewy, Evan and Jessica Loewy, Linda and Charles Consolvo, Michelle and John Bannon, and Gloria and Al Cassidy. You are ALL an inspiration to me to keep going, and to keep providing true value to the world and to keep helping people succeed at their goals investing. I am grateful to each of you for the many insights, observations and suggestions. Many of these appear in one form or another in this work.

Also, I am so fortunate to have worked with some of the finest subscribers and readers a long- term investor could have. ALL of them encouraged me to provide all this value to the world. I will respect their privacy by not naming them here, but without their patience, interest, support and motivation, my investment success would be an afterthought.

I would never be in this position without the opportunity that Rob Sckalor and Scott Greenberg gave me. They took a chance on me at the investment firm they own, and I will forever be grateful to them for their help and guidance along this incredible journey. The world would be a better place with more people like them. It has been one of my greatest privileges to be in the same room with such energetic, knowledgeable and caring people. I like to think that together we have built something to be proud of into the foreseeable future with this book.

My five years at the investment firm brought me into contact with some incredible analysts, traders and investors. I am forever grateful to each of them for putting up with me and teaching me along this incredible journey. A special thank you to my colleagues and friends -- Andrew Luscz, Aaron Smith, Conn Davis, Anwar Lockhart, Justin Wheatley, Ed Stinson, Mark Stridiron, Sophie Newbold and Bo Nichols.

I also want to thank some investing mentors who have helped me to map out the incredible vision I have of the future and what I hope to bring to the world: Charlie Munger, Whitney Tilson, Mohnish Pabrai, Guy Spier, Seth Klarman, Warren Buffett, and Mason Hawkins.

Last but certainly not least, I want to thank my wife, Shannon Neely, who I married on July 12, 2014. She is the most intelligent, motivated, caring, loving and ambitious woman I have ever met and, although she doesn't do it directly, she challenges me on a daily basis. And I love her for that. She was able to

provide the quintessential piece to this book: a different perspective from a non-investment-professional. Sometimes I get carried away with all the numbers and valuations. The analytical portion of the 5M™ Mental Model can get lost in translation sometimes. In fact it is the reason why so many individuals give up when they start out investing. I know it was a big goal but I wanted this book to be understood and used by everyone -- from High School Student to Investment Fund Manager. I knew that if I was able to explain technical aspects of investing in a simple manner that I could be onto something. She read every word of every chapter and made countless helpful recommendations.

Shannon is the person who challenged me the most to pursue my dreams and my passion of investing and creating value for people. She has worked as a consultant in the medical field for over 10 years in the process improvement space (lean six sigma). She believes that the work she does helps other people and she is dedicated to that cause. When I see her motivated to do great things in her field and help people, it reminds me that I have to get to that same level or above. I guess that is my competitive nature, but I love her for that; she keeps me on my toes in a very good way. I look forward to spending the rest of my life with her and starting a family! She will certainly be a great wife, mother and best friend.

I am forever thankful to each of the people mentioned above. I thank each and every one of them for their help and I will forever cherish their friendship!

Full responsibility of any errors in this book are borne only by me.

Bibliography and Guide To Additional Reading

Although I have lived the models, concepts, and lessons of this book for some period of time, I began researching and developing these mental models as far back at 2007. During this time, I've archived, collected, and read well over a thousand scholarly articles and white papers, scientific studies, hundreds of newspaper and magazine articles, and a decent" sized library of books and materials by some of the most renown experts and super investors in the world of investing.

Every one of the books listed below have played a major part in my life. Not only as an investor, but more importantly, as a well-rounded person. I simply want to pull back the curtains to my library of the best topics across multi-disciplinary subjects.

They've all somehow shaped who I am as a person. And they have helped to create not just the book you read here today, but the 5M™ Mental Model of value investing. A mental model that I will have with me the rest of my life. For that, I am eternally grateful to all the authors, editors, and collaborators below.

Thank You from the Bottom of My Heart. Enjoy!

Psychology

Flow: The Psychology of Optimal Experience by Mihaly Csikszentmihalyi

Influence: The Psychology of Persuasion by Robert Cialdini

The Art of Thinking Clearly by Rolf Dobelli

The 48 Laws of Power by Robert Greene

Thinking, Fast, and Slow by Daniel Kahneman

Willpower: Rediscovering the Greatest Human Strength by Roy Baumeister and John Tierney

Complex Adaptive Systems

At Home in the Universe: The Search for the Laws of Self-Organization and Complexity by Stuart Kauffman

Connected: The Surprising Power of Our Social Network and How They Shape Out Lives by Nicholas Christakis and James Fowler

Deep Simplicity: Bringing Order to Chaos and Complexity by John Gribbin

Emergence: The Connected Lives of Ants, Brains, Cities, and Software by Steven Johnson

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What's
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