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# The Focus Investing Series: Part 2

Written by:

Richard M. Rockwood

Introduction

This second article in the Focus Investing Series will focus on three parts of the investment equation: selecting great businesses to invest in, determining the proper price to pay for the business, and the psychology of investing. Since the idea of maintaining a concentrated portfolio is a key element of the focus investing philosophy, it is critical that focus investing practitioners be able to identify companies that have sustainable competitive advantages.

Finding companies that possess a durable competitive advantage is often the easiest part of the investment process. The tough part of investing is finding the combination of a great business at a great price. Investors should always remember that the price paid will always determine your future investment returns.

The last section of this article covers the psychology of investing, and it will show the investor what traits and habits will hinder them in their search for the best investment possibilities. The securities market can go through prolonged periods of irrational behavior and the investor should understand how these periods occur, and what behaviors they should avoid practicing.

Please keep in mind that the purpose of the focus investing series of articles is to provide interested parties with a broad overview of the focus approach towards investing.

## Chapter 1: Competitive Advantages

Let's start the discussion on how to identify great businesses with an examination of Michael Porter's thoughts on the competitive forces that affect industry profitability. Mr. Porter is a professor at Harvard and in 1980 wrote an excellent book on the subject called *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. I will try to sum up his thoughts on the subject in the following chart.

***Chart 1: Five Forces of Competition Models***

**I. Rivalry Among Existing Firms**

- What is the industry growth rate? If an industry is growing rapidly, competing firms don't need to grab market share from each other. If the industry is not growing, then firms will tend to attack each other in an attempt to steal market share. This can lead to irrational behavior as companies struggle to maintain their market share.
- The concentration and balance of industry power needs to be closely examined to determine the severity of the price competition.
- How does product and service differentiation affect the industry's competitive dynamics?
- Is it easy for an industry's customer base to change companies within the industry and still receive the same basic product or level of service quality?
- Is there a steep learning curve present, or are there other types of scale economics to consider in the industry under examination?
- Is their excess capacity in the industry?

**II. Threat of New Entrants**

- Are economies of scale relevant in the industry? If so it may be difficult for new entrants to gain a foothold in the industry under examination.
- Does the industry already have an established powerhouse that sets industry standards? If so, identify the source of this strong position (i.e. cost advantage, network effect, or high switching costs).
- Do the established firms have a hard-to-replicate distribution system? What would be the cost of creating a new distribution system? Think of the large competitive advantages Coca-Cola enjoys due to its worldwide distribution system.
- Do the established companies in the industry possess any legal barriers to entry, such as patents, licensing, or copyrights?

**III. Threat of Substitute Products**

- How willing and able are the industry customers to switch products and services? Are the products sold or the services offered by the company under examination have little to no differentiation with other companies' products and services?

**IV. Buying Power of Buyers**

- Do any companies in the industry sell an easy-to-replicate product or service? If so, price sensitivity becomes an issue and investors should look for low cost providers.
- Do any companies within the industry produce a product or provide a service that is considered vital to other companies' operations?

**V. Bargaining Power of Suppliers**

- Does the industry under examination have many efficient suppliers? Do one or two suppliers dominate the market?

Investors should keep these questions in mind when searching for a company in which to invest. In most cases, when a company is earning an abnormal profit, the intensity of competition will increase dramatically as additional companies try to enter the field and attempt to capture pieces of this abnormal profit. That is why finding a company with a sustainable competitive advantage is so important. For an example of a company with a sustainable competitive advantage, I suggest focus investors examine Moody's. This company competes in an industry with only two other competitors, and its brand is so strong that it is practically a requirement that companies have their debt rated by Moody's.

Competitive advantages often fall into two categories. These categories are cost leadership and product/service differentiation. Cost leadership enables a company to sell the same product or service that other firms are offering for a lower price, with comparable quality. These efficiencies usually result from the company having a lower cost of production (for example economies of scale or a higher efficiency production process). This competitive advantage is particularly important when the product being produced or the service being offered is a commodity.

A company can also attempt to maintain a competitive advantage by differentiating its products from others in its industry. The customer perceives that the differentiated product is of higher quality or has a high brand appeal. Tiffany is an excellent example of a company with this type of competitive advantage.

Mr. Warren E. Buffett, CEO of Berkshire Hathaway, has made several pertinent comments regarding competitive advantage over the years. Since he is one of the most successful investors of all time (and a very skilled writer), I have included several of his quotes below:

"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."[1]

"We like a business with enduring competitive advantages that is run by able and owner-oriented people. When these attributes exist, and when we can make purchases at sensible prices, it is hard to go wrong (a challenge we periodically manage to overcome.)"[2]

"…sustainable competitive advantages are the core of any business, and that's exactly the way we think. That is the key to investing. The best way to understand this is to study businesses that have achieved it. Ask yourself why there are no new entrants in the razor blade business. Or study Mrs. B [the founder of the Nebraska Furniture Mart, a Berkshire Hathaway-owned company].

Mr. Buffett has spoken extensively on the subject of competitive advantage for a very good reason. Investors in the process of examining businesses should be concentrating their efforts on two things: firstly, whether the business in question possesses a competitive advantage; and secondly, how sustainable it is.

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[1] Fortune Magazine dated 11/22/1999
[2] 1984 Berkshire Hathaway Annual Report

## Chapter 2: Assessing Companies

When examining a company as a potential investment, what should the investor look for? The first thing the investor should do is to try to find and examine companies that have competitive advantages. Investors should refer back to Chapter 1 for more information on assessing companies and their competitive advantages. Other areas to examine would be the economics of the business and its management team.

### Economics of the Business

Focus investors are looking for businesses that are experiencing strong tailwinds. They desire companies that ideally require small capital expenditures to grow sales, have minimal debt on their balance sheets, and earn high rates of return on their equity. They are willing to invest in quality businesses for fair prices.

The focus investor should be aware that great businesses can operate under several different business models. For instance, several great businesses, such as Costco, Nebraska Furniture Mart and Wal-Mart, use a high turnover/low margin business model. Other great businesses, Tiffany & Co., for example, make use of a low turnover/high margin business model. Focus investors should examine these great businesses individually to determine what elements of their business models made them so successful.

Focus investors should look closely at competitors in the industry to assess how great a threat they are to the company under examination. Competition that doesn't behave rationally can really harm the economics of even the best-run businesses. Avoid investing in industries that are involved in price wars on a regular basis, as this behavior tends to be self-destructive and will hurt everyone's financial performance in the industry in question.

The focus investor should also examine several financial ratios that will help them understand the economics of the business they are examining. One of the first ratios that a focus investor should look at is the firm's return on equity (ROE).

ROE can be broken down into three separate aspects. The first aspect to calculate is the company's return on sales (Net Income/Sales). This calculation will help the investor assess the profitability of the company. The second aspect to be calculated is the company's asset turnover (Sales/Asses). This calculation will help the investor assess the operational performance of the company. The last aspect to be calculated is the company's financial leverage (Assets/Equity). This last calculation will allow the investor to examine the company's financial flexibility.

Return on equity can be used as a tool to determine what type of return the company in question is able to achieve on assets employed. For instance, if a company is able to achieve a 15% return on its equity, then, in effect, it has been able to create 15 cents in new assets per dollar invested.

Focus investors should also examine the firm's profit margins and ask themselves if they are in line with their competitors. If they are noticeably higher or lower than the industry average, the investors should investigate and determine the reasons for the difference. If margins are noticeably higher than the industry average, the investor may also want to investigate whether the margins have historically been at the current level. Focus investors should also keep in mind that a high-margin business tends to attract competition, unless the company in question has some type of competitive advantage.

It is also important to examine the company's financial history and try to determine how recessions and industry downturns affect the firm's results. Value Line is a tool that helps investors in examining the historical financial records of approximately 1,700 companies. Focus investors should seek out companies that have consistently produced solid results over a long time period. Stable businesses with repeat-use products (for example Gillette) should always be examined closely. Cash flows from these types of business models are typically more accurate to model and usually the market leaders have solid moats around their businesses.

Management

Although the economics of a business will often be the determining factor in whether or not a company should be considered for possible investment, the management team of the company is also an important consideration.

An ideal management team should be strong advocates for the company's shareholders. They should be oriented towards the long-term, as well as rational capital allocaters. The focus investor should be able to get a good feel for a management team simply by closely observing their actions and behavior. For example, in the letters to shareholders' section of the annual report, do they write letters which portray both the positive and negative aspects of the business? Have they paid rational prices for acquisitions they have made? Do they have rational compensation structures? Are they continually reinforcing and expanding the moat around their businesses? These are just a few ways an investor can form an opinion of a management team without being able to meet with them.

Another item to watch for is if the management (and/or founders) of the firm under examination tend to "eat their own cooking". Has management acquired a stake in the company via open market purchases? If they have, this could be a very positive sign that they will tend to think like a long-term business owner, as well as a sign of how passionate and focused they are on the company and its long-term success.

Focus investors should ideally be searching for a business that has healthy enough economics for it to be able to withstand a period of neglect, because over the years a bad manager is bound to operate the company at some time or another.

This quote from Mr. Buffett serves as a fitting conclusion to this section on the importance of management, and is well worth remembering: "With few exceptions, when a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."[3]

[3] 1989 Berkshire Hathaway Annual Report

## Chapter 3: Intrinsic Value

Once the focus investor has selected a business to invest in that they believe possesses good business economics and has an excellent, shareholder-friendly management team, the next item to focus on is the current price being quoted for that business.

A business that is publicly traded rarely trades at its intrinsic value. One reason for this is that all investors calculate intrinsic value in a slightly different manner. For instance, one investor might have a slightly different viewpoint with regard to the direction of interest rates; another investor might be more optimistic about the company's future generation of cash flows. These differences, at times, can present the investor with attractive entry points when the general market is overly pessimistic about a certain company or industry.

How do I define intrinsic value? I agree with Mr. Buffett's definition in the 1996 Berkshire Hathaway Owner's Manual: "Intrinsic value can be defined simply: it is the discounted value of the cash that can be taken out of a business during its remaining life." I also believe that the definition provided by Graham and Dodd in *Security Analysis* is correct. They defined intrinsic value as the value which is justified by assets, earnings, dividends, definite prospects and the management factor.

Basically, intrinsic value is a measure of all the cash a company will generate in future years, discounted to the value of that cash generation in today's dollar. The further in the future the cash flows are, the less they are worth today (the time value of money concept). The discounted cash flow method is the primary method I use to calculate a company's intrinsic value. I would refer the reader back to Chart 4 in Part 1 of the Focus Investing Series to see an example of how this is calculated.

Investors can also value a firm by trying to determine what the company would sell for if it were placed on the auction block, or finding out what comparable companies have sold for in recent transactions. The latter method of company valuationshould be treated with some degree of skepticism, however, since CEOs can fall prey to excessive optimism just as easily as individual investors can.

Benjamin Graham's "margin of safety" concept fits well with the intrinsic value concept, stating that the investor should only pay a given price for a business that allows for a margin of error. In this way the investor can still expect to earn a reasonable return even if the business doesn't perform as initially expected.

## Chapter 4: Psychology of Investing

The efficient market theory states that since the stock market is so quick to adjust to new information, security prices very quickly represent all the public and private information available. This is not a realistic tenet, however: investors tend to fall prey to their emotions and as a group may decrease a stock price below intrinsic value when bad news initially arrives at the marketplace. By the same token, they tend to increase stock prices to levels above intrinsic value when unanticipated good news arrives at the marketplace. Letting emotions control the investment decision-making process can lead to sub-standard investment returns. In an effort to understand how these emotions affect the investment decision-making process, several common emotional errors will be covered here in the hopes that, once the investor is aware of them, they can be avoided.

The most common thought-processing errors occur when individuals use shortcuts to make investment decisions. The field of Behavioral Finance refers to these shortcuts as "heuristics". These shortcuts are vital in other aspects of an investor's life. Imagine making normal day-to-day decisions with the same intensity as when making the decision on what college to attend after graduating high school. So the shortcuts are vital to anyone leading a normal life, but successful investors must learn to avoid these mental shortcuts when investing.

These shortcuts are influenced by several psychological factors:

Availability Bias - Individuals tend to have a stronger recollection of information recently obtained or information that has left a strong impression on them. These memories can influence the decision-making process when making investment choices. An example of this behaviour would be an investor buying a stock solely because a favorite money manager talks it up on a CNBC interview.

Representativeness - Most people make decisions based on stereotypes they have developed over time. "Reversion to the mean" is an example of this psychological factor. For instance, many investors may believe that the market will decline in value in a given year, just because it has gone up every year for the last five years and is now due for a fall. This is not a rational way of looking at the situation. The market is not likely to experience a decline simply because it has risen for the last five years. There will always be many factors involved in any move in the direction of the market, but the investor will never to be able to forecast future movements based on past performance.

Another related example of representativeness is a concept called gambler's fallacy. Gamblers tend to believe the notion that if a fair coin has landed on heads six times in a row, it is more likely to land tails up on the seventh toss. In fact, the coin has the same chance of landing heads up or tails up on any given toss, so any heads up or tails up streak means nothing when considering the probability of which side will land face up on the next toss.

This can be seen in the investment field, when investors watch for trends in the movement of a stock's price or a company's earnings. These so-called investors have concluded that since a business' stock price or earnings have steadily increased over the last four quarters, it will certainly continue this trend into the next quarter. I fail to understand the rationality of this process of investment selection.

Hersh Shefrin says it best in this quote from his book, *Beyond Fear and Greed*:

"The point is markets behave a lot like coin tosses. Coin tosses produce interesting patterns, but past patterns provide little if no guidance about how to predict patterns of the future."

Over-confidence **–** Most active investors believe they possess superior capabilities when it comes to stock selection, or else they would invest in actively managed mutual funds or funds that track the performance of various stock market indexes. In fact, most investors would probably be better off selecting a passive investment process, such as investing in a low cost index fund.

Anchoring – Investors have a tendency to stay on a course of action once it has been decided upon. For example, if investors watch a businesses stock price trade within a certain price range, they may come to believe it should continue to trade within that range and make future purchase or selling decisions based on these ranges. I say let the business economics decide when to buy or sell, not the price range in which the stock is trading.

Excessive Optimism – As has been shown in a report by Barber and Owen, the majority of investors fall prey to over-stimulation and over-confidence in their ability to predict short-term trends and, as a result, they trade in and out of their holdings much too frequently. This frenzied trading increases the amount of choices that must be made correctly; it increases trading costs; and it increases the amount of taxes that will have to be paid. The combination of all of these factors greatly increases the probability that any investor practicing this behavior will under-perform in the market.

Investors should realize they will not always make the correct decisions in investment selection but, when an error is made, the important thing is to examine how it occurred and vow not to repeat the same mistake. They should also realize that it is not rational to expect the market to always increase by 24%, year in and year out. For a fascinating look into what Mr. Buffet thinks the direction of future stock market returns will be and how he arrives at his conclusions, I strongly recommend that investors read his 1999 and 2001 articles which appeared in *Fortune* magazine. The link section of FocusInvestor.com contains hyperlinks to both of these articles.

Illusion of Validity – In the course of their research, investors will often ignore evidence that goes against the conclusions they have already formed. They may similarly place too high a value on evidence that agrees with their conclusions, while disregarding information that refutes their theories. This behavior is called confirmation bias and may lead investors to act confidently on views that may, in fact, be incorrect.

Hindsight Bias – The examination of past market behavior and/or results can lead investors to falsely extrapolate past trends into future predicted behavior. This is dangerous reasoning, as past behavior is certainly not a good indicator of the future behavior of the market. It is always easier to see how markets reacted to stimuli when you already understand the outcome which came to pass.

In addition to heuristic-driven errors, "frame dependence" is another area in which the investor's thought-processing abilities might break down. Frame dependence occurs when errors are made in an investor's perceptions of risk and return as a result of how decision problems are presented to them. Three examples will be covered: loss aversion & loss realization; mental accounting and risk tolerance; and regret complex.

## Loss Aversion and Loss Realization

Investors have a distinct aversion to loss and will avoid the perceived possibility of sustaining a loss if at all possible. In their 1982 book, *Judgement under Uncertainty: Heuristics & Biases*, Daniel Kahneman and Amos Tverksky found that a loss resulted in two and a half times the emotional impact of an equivalent gain. This may explain why some people are unable to invest in the stock market; they just can't face the fact that they may experience a short-term loss, irrespective of the amount of long-term gains that could possibly be attained. This fact may also explain why lotteries are so popular; the amount of money being risked is so small on an individual ticket level that the impact of its loss is minimal.

Loss realization is another example of frame dependence. If an investment has been made, and the price has since declined, some investors find it difficult to sell and realize the loss (this applies only if the business economics have declined along with the stock price). The investor finds it difficult to admit a mistake may have been made when purchasing the investment in the first place, and believes the stock price (or business performance) will rebound. Focus investors shouldn't make the mistake of holding onto losing investments because it is too hard to admit an error has occurred.

Meir Statman and Hersh Shefrin, in a 1985 article in the *Journal of Finance*, confirm the idea that investors sell the winners in their portfolio too early and hold their losers too long. Focus investors should admit the error, take the loss, investigate how the error occurred and apply the lessons learned in future investing decisions.

### Mental Accounting and Risk Tolerance

Mental accounting occurs when people treat money decisions differently based on how the money was earned, or what source it originated from. Here are two examples of this behavior:

John has just received $50,000 in a surprise inheritance. He subconsciously considers this "free" money; after all, he didn't plan to have it and didn't work hard to accumulate it. John decides that, rather than investing all of it, he will buy a new car and take a much-deserved vacation. Even though there is nothing wrong with this activity, it is interesting since John would probably never consider buying a new car or taking a vacation with the $50,000 he has saved in his retirement plan. Hence, he has placed this new money in a different mental account.

Sue has just won $500 in a poker game. She has been lucky and has grown her stake to $600 from the $100 with which she began gambling. Sue's mental accounting classifies this additional $500 as free money. Sue decides to risk the $500 in profit, and keeps betting. By the end of the night she leaves, happy that she still has $150 in her pocket, $50 more than she started with.

Sue and John have both made mental accounting errors. John made decisions he would normally not have contemplated with the money he received, and Sue was happy to leave with $50 more than she had when she entered the casino. Sue doesn't realize that she actually lost $450 during her visit, because she classified the other $450 in her mind as free money.

To avoid these frame dependence errors, try not to focus on short-term losses in your investment portfolio. Overly conservative portfolios can result in an under-performing portfolio (avoid having a portfolio in 80% US Treasury notes and 20% in stocks unless good opportunities to invest the cash are scarce). Focus investors should always keep in mind the time frame they have when investing: why worry over a short-term dip in a stock price that has no correlation with its intrinsic value in a company you have investigated thoroughly? Remember, you only have to follow the crowd if you believe they are correct in a given instance. If your reasoning is correct, don't be upset that the crowd is not thinking the same thoughts. Take advantage of the opportunity being presented to you.

Regret Complex

Some investors choose investment options they believe will cause them the least amount of regret at the end of the day. This can cause irrational behavior, such as a potential investor deciding not to invest in equities and instead purchasing certificates of deposits at a local bank, because he or she simply can't face the possibility of short-term losses. This choice will minimize the possibility of regret if equities decline, but also cause a major loss of wealth over time due to inflation and the better returns stocks have historically provided over certificates of deposit. Some potential investors just can't deal with the possibility that they might be responsible for making a bad decision, and this results in irrational behavior.

The negative impact of experiencing the regret complex can cause irrational behavior when investors experience their first bear market. If they don't have the right temperament, they will regret ever having invested in equities in the first place, and may decide to pull all of their money out of the market (probably at the worst possible time), which is an extremely bad decision to make. Investors shouldn't summarily dismiss this concept if they haven't experienced a significant downturn in their portfolio or the market, as they never know how they will react to this situation.

Delayed Gratification

What is the easiest way to become wealthy? Be frugal and under-spend your income (live below your means) and follow an appropriate investing strategy for the long-term. Here is what Thomas Stanley and William Danko observed in their book, *The Millionaire Next Door*:

"What have we dscovered in our research? Mainly, that building wealth takes discipline, sacrifice, and hard work. Do you really want to become financially independent? Are you and your family willing to reorient your lifestyle to achieve this goal? If you are willing to make the necessary trade-offs of your time, energy, and consumption habits, however, you can begin building wealth and achieving financial independence."

I agree completely and would only add that I believe the focused investing strategy has the potential to aid certain investors in the struggle to become financially independent. Here is another interesting quote from a book written by Merryle Rukeyser, *The Common Sense of Money and Investments*:

"It takes a human being of some imagination and economic intelligence to forego immediate gratifications for the expectation of future realizations of happiness. And yet the economically astute will feel to a large extent repaid for avoiding the temptation to spend by the consciousness that tomorrow has to some extent been provided for. Instead of the fun of spending all surplus funds on the theater, on expensive furs, and on other vehicles of self-indulgence, the saver will have bought immunity from the worries and vague fears of poverty. It has been wisely observed that thrift involves a transfer of part of income to capital. Thrift also entails tying the future to the present."

## Chapter 5: Conclusion

The successful focus investor must be able to select companies that have enduring competitive advantages which are selling for a great price. Additionally they must have a keen understanding of the psychology of investing. If they don't, they are truly operating at a severe disadvantage.

In conclusion the investor should always remember that some types of risk are not worth taking. Pick the risk best suited for you to achieve financial independence in the long run. I can think of no better way to conclude this series than with a quote from Benjamin Graham, from a 1974 lecture:

"Let me close with a few words of counsel from an 80-year-old veteran of many a bull and many a bear market. Do those things as an analyst that you know you can do well, and only those things. If you can really beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're really good at picking the stocks most likely to succeed in the next 12 months, base your work on that endeavor. If you can foretell the next important development in the economy, or in technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination and by continuous testing of performance, that you have what it takes to produce worthwhile results.

"If you believe - as I have always believed - that the value [focus] approach is inherently sound, workable, and profitable. Stick to it, and don't be led astray by Wall Street's fashions, illusions, and its constant chase after the fast dollar. It is worth emphasizing that it does not take a genius or a superior talent to be successful as a value analyst. What it needs is, first, reasonably good intelligence; second, sound principles of operation; third, and most important, firmness of character."

Please feel free to visit the FocusInvestor.com message board at http://www.focusinvestor.com/cgi-bin/forum/ikonboard.cgi to discuss any topics in this article in more detail or email me at rich@focusinvestor.com.

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