Security checklist

Our investment approach is rigorous, thorough, yet simple. We’ll start off by following the literature by Benjamin Graham & David Dodd, but possibly branch out to other styles. Note: we must check if the security can be invested in cost effectively.

This approach is aimed at buying shares in companies at bargain prices. This can be done by determining a figure for the intrinsic value of each business and seeing if this is sufficiently below market price. This figure will be derived from a very basic formula: average earnings times the **capitalization factor**. Easy as the former may be to obtain, working out the latter brings a high level of complexity with no one method or school of thought guaranteed to give the most accurate answer.

Once we have worked this out, we’ll use it to answer the following questions:

* Is your value higher than market price? If so, is there a sufficient margin of safety?
* Can it be bought for less than value to private investor

Along with other concepts of valuation:

* P/E ratio compared with peers. Use a five-year or three-year average
* Graham & Dodd – If price < working capital, this is a very good buy (given decent earnings and prospects). 2/3 is a good measure

Below is a checklist of all factors thought of so far that should be considered and used to compute the cap rate.

This is split into two parts – quantitative and qualitative – and an analyst should not treat them as separate, but complimentary.

# Quantitative analysis (most of which should be compared with sector peers)

* First things first: don’t jump at a company without looking at sector peers/competitors
* A decent regular income?
  + Dividend yield?
  + Consistency
  + Is the dividend growing?
  + Graham & Dodd – withholding dividends does more harm than good usually (check this)
  + Provide their forward dividend yield – are they continuing to pay or have they cancelled? (Yahoo Finance)
* Profitability – unless it is very new, a business should make a profit, period.
  + Net profit
  + Gross profit
  + Operating (EBIT) profit
  + ROE, along with DuPont analysis – is this heavily influenced by leverage?
  + Profitability is important, but must always be observed alongside the cashflow statement
* Cash flow
  + Probably the most important part of financials
  + Is it consistent, or relatively lumpy?
  + Where are their inflows coming from, mainly?
  + FCFE – see if your dividends are financed with debt at all
  + Eliminate ‘unusual items’ of earnings to determine real earnings power. Going back to nonrecurrent items, look at list given on page 134 of An Intelligent Investor (profit or loss on sale of fixed assets, for instance). Strip these out, and you’re left with the regular income.
  + Adjust for inventory valuation method
* Financial health (important for withstanding economic shocks)
  + Capital structure, along with the relevant ratios
  + Leverage – how in debt is the business?
  + Liquidity – liquidity ratios, NWC
    - Deduct ‘small’ liabilities before common stock interest before calculating working capital
  + Bond analysis shows their ability to withstand economic shocks
    - Minimum coverage of periodic payments (e.g. interest coverage ratio)
  + Stock-Equity ratio – price of issues to debt face value
  + Efficiency – inventory turnover, CCC, OCC etc.
* Economy
  + GNP: GNP – industry – company
  + Demand factors: fuel costs, raw materials etc.
* Footnotes!
  + Are there financial items in the footnotes which could be significant
* Forward figures
  + Analyst projections have some – but perhaps limited – use. These will be useful in calculating projected future cash flows.
  + Perhaps do a sense check on the quality of these estimates. Are the analysts from respectable institutions? How accurate have their estimates been in the past?
* Environmental/RE score
  + You are not investing in an index, so this should only be a light contributor
* Scoring
  + Once compared with sector peers, you should derive Z scores for these. Use norm norm and blom norm

# Qualitative analysis

* What do they do? Are they a conglomerate or individual company? What is there main line of business?
* Future prospects; what are the company planning to do and in what amount of time? Is this realistic? Do they have enough cash at hand or favourable enough financials to obtain credit?
* Market structure – are they a monopoly? What is the concentration of this market?
* Simply, do they sell *good* products. People will notice if they are selling crap, and this will affect stock price further down the line
* Engagement is very important – contact investor relations if you need more information – Eversource and Orsted are great examples
* Every now and again, check in on the company. You want to make sure they are still keeping their promises/meeting expectations.
* What is the company doing to solve the environmental problem? Are they ready for further/stricter regulation?
* What’s management looking like? Are they prudent? Aggressive? Narcissistic? Fair? What is their track record?
* If a company doesn’t really have a sector/range of competitors, compare valuation to market
* Who else owns them? Are they smart people/institutions? E.g. the majority of Greggs shareholders being institutional investors such as Blackrock is a source of confidence.
* Look at the website. Perhaps you can tell a lot about a company by how good/bad their website is.

# Sources

* S&P Capital IQ – great for financial data.
* Barchart.com, Financial Times, Economist, Marketwatch, City Falcon – all good for searching for ideas and news about current/prospective investments
* Annual or Integrated, 10K and 10Q reports

# Methodology

* Read up on them – analyst reports from CAPIQ, general news, and Annual Reports
* Use CAPIQ for sector classification
* Using python to pull data from Excel sheets from CAPIQ

As long as this list may seem, DO NOT overanalyse. Some companies/industries will require deeper investigation than others, and not every corner of the business needs to be looked at initially. What’s more, if a company doesn’t seem promising on the surface, it is probably more efficient and worthwhile to go and look at something else.