

Mod note (Andy): Throwback Thursday, this post originally went up on 4/23/12.

Hey guys, so after some encouragement from a few of you guys I'm gonna go ahead and start a bit of a series of posts on my experience in the [hedge fund industry \(/guide/hedge-fund-interview-questions/\)](/guide/hedge-fund-interview-questions/), particularly in how one goes from the start of an investment idea, to taking a position, to monitoring the position, and finally what happens when it's time to close it out. I'll explain all of that and will also try and do Q&A in this thread also to help anyone with specific questions. Before I get into that, here is a bit about my background that will help you guys understand what my investment approach is like.

As some of you know, I did my undergrad at Penn, specifically Wharton, majoring in finance. I hate making the distinction that I was in Wharton and not "just Penn" but it's relevant here so I'll deal with it. I did my [summer analyst \(/guide/wso-internship-guide/\)](/guide/wso-internship-guide/) stint at a pretty value-intensive AM (asset management)/[HF \(hedge fund\) \(/finance-dictionary/what-is-a-hedge-fund-HF/\)](/finance-dictionary/what-is-a-hedge-fund-HF/) hybrid company where I accepted full-time and spent about 1.5 years there before getting poached by a fairly large hedge fund. I spent two years there and was fortunate enough to get out right about the time they started heading downhill, and have now been working at a smaller fund for about 8 months. My current fund is decently large in terms of AUM (a little over 2b) but we don't have many analyst with a single PM who runs everything. We are a **long/short fund with a heavy emphasis on value**. The best part about my job is how much freedom we are given as analysts and how flat the structure is, unlike my last fund which was very structured in comparison and much larger by headcount. I can answer more about my background in the Q&A if I missed anything. It's late.

Anyway, so I will try and go through the **life cycle of a successful investment idea** here which should hopefully give people an idea of what a day in the life is like and what is important in looking for a good idea. Here goes...

**Sourcing an idea** is really tough for me to explain. A lot of my ideas come from really random places. My most recent idea came because my girlfriend forced me to download an app on my phone and play a game with her, which I thought was absolutely stupid and couldn't be more than a fad. (Obviously you all know what company I'm talking about now) Sometimes I walk into a store and realize how much I've hated that business... or maybe how much I've loved it. These random sources are hard to quantify, so I can't really explain how I source those, but more traditionally I do spend a lot of time looking through newspapers and keeping up on current events to see what companies are hot or hated, and if I have some basis for looking further I can go from there and start researching if the company is in my circle of competency. Sometimes I'll spend time reading through 13-F's

and if I see the same name too many times I'll start to look at the company and see if there's something to be looked at. The only real criteria for the source of an idea for me is hotness. Has the stock been beaten up recently or has it had a huge ride up? The answer to that question doesn't necessarily have to be yes, but for me it usually is. If a company has been hated on recently it's going to be a better value, and vice versa for potential short candidates. Anyway, so let's say you have sourced your idea and done very preliminary research, now it's time to actually do some analysis...

The first thing I do is **make sure I understand the industry**. I'll spend time reading industry reports, reading the most recent 10-k ([/finance-dictionary/what-is-a-10K](http://finance-dictionary.com/what-is-a-10K))'s of the target company and major competitors, and reading the past 3-4 quarterly reports and earnings transcripts in their entirety. Once I do that I usually have a good idea of how the industry works and what the main metrics are. If I don't, I might head out to a trade conference or go to more aggressive lengths to make sure I answer all the basic questions I have about the way a firm would do business in this space. After that's done I can start building the backbone of my model. I never use a template since I believe every company needs to be modeled differently, so I'll start from scratch. The biggest thing I want is to figure out how this company drives revenue, and what pricing power is like. I don't want to go into details on the model but basically the main purpose of it is to look at what earnings have been like, what margins look like, and what the main points of the capital structure are and how management has handled the company up to this point. I love consistency here. Obviously I want to find what Buffett would describe (<http://tinyurl.com/3b4fmvt>) as financial evidence for the "durable competitive advantage." I won't finish the model at this point but I will have enough blank space on it to find out what I need to answer to make my assumptions for the future.

From here, I'll go line item by line item analyzing the trend of whatever account I'm looking at on the financial statement, and if I have any questions about what's happened with it (let's say receivable spiked enormously in the most recent year), then I'll write that down and through this process start forming a list of questions for IR or management, depending on the size of the company. I always like to speak with management eventually but for my first list of questions I actually prefer IR because they know less and sometimes will either answer the question the way management wouldn't want them to, or will be blissfully ignorant to whatever I'm asking about, which is usually some sort of red flag that could help if this is a short idea. Let's say this is a long idea though, and IR is able to answer all my questions sufficiently and I start to feel good about the prospects of the company.

**At this point it's time to talk to management, hopefully the CFO if possible.** Since I'm typically looking at a company that's been beat up or run up, I want to get an idea of how legitimate the reasoning was for the move, and there's nobody better to talk to than the

CFO about that. I can't really explain the nuances of learning things from management, but with experience you are able to evaluate management a lot better and I think this is one of the most underrated parts of the investing.

So now I have an idea I like. I'll typically spend a little bit of time looking at some technical analysis and some reasoning behind getting in at a certain price. I have a model with a bull case, base case, and bear case for my company and am able to develop a target price range and target time frame for the investment. I'll pitch this to my boss, our PM, and engage in some dialogue about this. He usually knows a lot about the company no matter what it is, and often will have additional questions for me to go out and answer. Sometimes I'll have to get in touch with former employees, take a walk through the store or whatever it may be, or even buy the product and show it to my boss (example: made him play Words with Friends until he got tired of it. Took 3 days.) He'll generally take my advice on sizing based on my conviction, but it also depends on what our capital situation is like and what sector the company is in or the volatility and risk behind the investment. He agrees to go long for 1.5% of the fund.

**Now that we have a significant investment in the company, I have maintenance duties.**

Most of the time this means just keeping track of the movement on the stock, attending meetings with management periodically, sitting on earnings calls, and reading all company filings as they come out. The main goal of maintenance is to make sure that our agreed-upon thesis for investing in the company is still valid, and that nothing has changed that would make this company lose its competitive advantage, no longer be considered a "good" company by our standards, etc. This is most hectic around earnings time, especially when management suggests that they may not perform so well. They don't do this explicitly, but once you spend enough time on a company and with its people, you can tell when they're having a hard quarter. I'll keep my eye on all of this while I keep sourcing and working on other ideas.







**If any of the criteria I outlined when we initially invested in the company is broken, we will exit the position.** Also, if we believe we have broken into a price range that meets whatever target I have set out, we will also exit. At this point the investment has reached the end of the line and we're all done. With some companies that have extremely impressive advantages and continue to grow earnings and increase shareholder value, we may hold an investment indefinitely though with no target price range. During maintenance I may begin altering my target price depending on how earnings have been looking and what the industry landscape has done since the beginning of the research process.

I hope this stuff helps a bit and that it wasn't too long or boring to read. It's kind of hard to explain the actual investment and research process since it's always different and a lot of it is art rather than science when using the approach I do. I like to believe that experience is

really important and urge **anyone who wants to work at a value-based fund to spend a ton of time paying attention to the markets and reading 10-K's**. I probably spend most of my day either reading reports or speaking with management or sell-side analysts about different companies and industries.

The great part about my job is that **I don't have to be in the office or putting in face time**. We don't care that you're "working your ass off," we only care that you know how to analyze a company and can provide a reasonable thesis behind an investment. Oh, and you won't last long if you're picking losers. Work all day and night but pick losers and you'll be fired. Only show up at the office for 5 minutes but spend that 5 minutes pitching a winner and you could be seeing 7 figures. All I know is if I do my best work in a sewer in Harlem, that's where I'll be.

I'll take Q&A from anyone through PM and post them in the comments anonymously along with my answers. Hope this helped guys!

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