**Chapter 1 How to Generate Investment Ideas**

Quantitative methods – utilizing financial and/or operating metrics

Qualitative methods – assessing management strength, corporate culture, competitive advantages

*The best method of generating ideas is the one that gives you the largest number of opportunities.*

* you can’t manufacture investment opportunities,
* you need to be patient, and
* you have to be ready for the right opportunities

Good ideas are rare and thus consistent success in the stock market is elusive. Investors with the best long-term track records have made most of their money with just a handful of ideas. Most investments you make will produce mediocre results, but a few can provide outstanding results.

The best investment opportunities usually come in big waves such as when entire markets decline:

* Asian financial crisis of 1997 to 1998,
* internet bubble of 2000,
* the recession of 2007, and
* Corona virus of 2020)

There were many buying opportunities in 2008 after the S&P had dropped 36%. This steep decline was caused by forced selling much of which was required to fund client redemptions (this was technical trading pressure that overshadowed valuation).

The stock market has a way of magnifying different types of business and industry-wide risks that cause the stock prices of businesses to drop. Ask yourself:

* what areas of the stock market are investors fleeing from and why?
* you may want to begin by looking at the percentage change in prices of certain industries
* identify those areas where the outlook is most pessimistic and identify whether the sources of pessimism are temporary or permanent

Be wary of the sources of information that you use to support or refute your investment thesis (accuracy, bias, agenda, track record, purpose, etc…). Rely on your own personal solid base of research on companies and industries when assimilating information into your thesis. Be wary of exciting new trends that turn out to be fads. Wall Street is good at pitching stories and investors tend to get excited by what they believe is an important new trend.

It is better to stick to news and information services that are fact-based. Be wary of self-serving recommendations and less-than-transparent presentations of results.

Perform basic sanity checks. Sun Microsystems own CEO, Scott McNealy, warned “At 10x revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends.” This assumes some head-scratching hurdles such as getting shareholder approval for such a plan and also not paying any expenses or taxes and not reinvesting in any R&D. “Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are?”

**How to Spot Investment Bubbles**

“Where is a lot of money being made very quickly?” What industries are the new billionaires coming from? Monitor IPOs coming to market – are IPOs that are quickly rising in price concentrated in a certain industry? Here are a few signs of a bubble:

1. Lots of available capital
2. Higher levels of leverage
3. Decreased discipline from lenders as they try to get higher returns than through conventional lending guidelines.
4. Decreased responsibility for the borrower, combining high leverage and looser lending terms.

A stock screen can be used to filter stocks using pre-selected criteria. ***One of the main limitations of stock screens is that they use GAAP numbers***, which rarely present a realistic financial picture of a business. Investors often need to adjust GAAP earnings to understand the real earnings of a business.

New lows listings can also be a source for new ideas. “… a lot of investors will put together a screen of low PB or low PE stocks, but usually 90% of the companies on the screen are cheap for a good reason.” Separate companies that deserve to be on the list from those that may only be suffering from a temporary problem.

Following other investment managers… it is typically when managers are out of favor that you should be following their holdings. There are several disadvantages to following other managers:

* For every 10 investments a successful investment manager makes, only one will appreciate substantially, contributing outsized returns to their record, while others will either mildly perform or underperform.
* You typically will not know the reason why a certain manager is buying or selling a stock.
* No matter how good a manager is, all managers will make mistakes.
* Managers can change their strategies over time.

Casually read the business press (such as Las Vegas Review Journal). As you read the articles, you’ll not only ground yourself in industry basics, but you’ll uncover descriptions of management teams you’d like to invest with. ***Focus of those articles that are not success stories but rather those about distress, to give you better odds of finding a well-priced investment***.

You can buy a few shares in a stock to meets your criteria to force yourself to follow the business. Although it is more exciting to discover opportunities outside of your portfolio, it may not necessarily be more beneficial. If a stock you hold drops in price, this may present the best investment opportunity for you, especially compared to a stock you know less well.

At one point, Whole Foods Market traded at close to 4x enterprise value (EV) to FCF, which means you could have bought the whole business (including debt net of cash) and paid for it in four years out of existing ***depressed FCF***.

**How to Filter Your Investment Ideas**

Filters allow you to reject investment ideas quickly. Criteria can be as simple as looking for a simple business with a large market opportunity, managed by a great management, and trading at a low price. You can also set criteria of what you do not want to invest in.

By articulating and following strict criteria, you can put the odds of making a successful investment in your favor. You can also put in constraints such as:

1. must have a recurring revenue stream
2. high organic growth (i.e. growth not derived from acquiring or merging with other businesses)
3. management with long proven tenure
4. strong competitive moat
5. strong existing or potential financial characteristics (e.g. high FCF)
6. high existing or potential returns on invested capital
7. limited competition
8. low capex requirements
9. diversified customer vase
10. strong balance sheet

Assessing all of your requirements together for a specific investment allows you to understand the tradeoffs you are making (e.g. a company may have a strong competitive advantage unfortunately coupled with limited future growth prospects). The more closely a business meets your stringent criteria, the less risk you are taking. If a business meets only four or five of your criteria, you can usually pass on the business, as most investment mistakes are made when you stretch your criteria.

Once you add an investment to your list you should begin learning about the business and management team and track its valuation using financial metrics such as:

1. TEV / EBIT
2. TEV / EBITDA
3. TEV / normalized earnings
4. Pre-tax earnings yield
5. Debt to EBITDA
6. EBIT / interest expense
7. FCF yield EV
8. FCF yield Market
9. Dividend yield (%) EV
10. Last market price
11. FCF estimate
12. Target price
13. Stock price vs target price

Because of the GAAP issues mentioned earlier, you may want to avoid using valuation metrics such as PE ratios. It is critical to remain disciplined on price. Brad Leonard (BML Capital Management) pays three times EV to EBITDA for a stock and also prefers to buy businesses that do not need a lot of maintenance capex and also does not carry a lot of debt. Conversely paying a 5% earnings yield (earnings / market cap) on depressed earnings would not really be that cheap.

The ability to make comparisons is one of the biggest advantages of maintaining a list of investment ideas in a spreadsheet. By comparing existing holdings with hundreds of potential investment opportunities rather than a limited set, you increase the probability of making good investments and avoiding bad ones. The more comparisons you can make, the higher the probability of uncovering an investment idea.

When you identify a unique business and/or superior management team, add the business to your inventory of ideas or watch list, regardless of its current valuation.

Once you have some ideas of the companies you’re considering investing in, there are a couple of questions you should ask yourself before getting into the nitty-gritty of researching those businesses.

**Chapter 2 Understanding the Business – The Basics**

A structured approach should be used when researching a business. The most basic questions involve getting at what a business really does and how does it make money.

If you have a solid understanding of what a company does and can explain it simply, you are less likely to waste time on tangential issues as you go into more depth.

After gathering basic information on a business, you should examine the company’s success and commitment in foreign markets.

Before starting to analyze a business, ask yourself if you are truly interested in learning more about the business and the industry in which it operates.

* **Do I want to spend a lot of time learning about this business?**
* **How would you evaluated this business if you were to become its CEO?**

To understand how a business operates, read the business description found in item 1 of the 10K. After reading this section carefully, write in your own words how the business operates. For example, how does the business manufacture products or produce its services? How does it distribute these goods and services to the customer (try to visualize how a product or service is delivered)?

Next, visit the website of the business to better understand what the products and services look like. Your goal is to explain how the business operates to a friend who has limited business knowledge.

* **Can you describe how the business operates, in your own words?**

If you’re having a difficult time understanding a business, ask what the customer’s world would look like without the product or service. Another method you can use to simplify a business description is to find an analogy that best explains how the business operates.

* **How does the business make money?**

It is critical to summarize how a business generates earnings. If you can’t understand how a business makes money, then you should not invest in it. In this summary it is important to articulate both the sources and uses of funds.

* **How has the business evolved over time?**

A historical perspective on a business provides both a deeper understanding and useful insight into its competitive advantage. You can better understand if its success and failures are dues to brilliant / incompetent management or simply right / wrong timing.

If the business has a particularly complex story or has made many acquisitions, answering this question is especially useful. Three sources of evolutionary history include:

1. The company’s website
2. the International Directory of Company Histories published by Gale
3. the past 10 years of the company’s 10K

* **In what foreign markets does the business operate, and what are the risks of operating in this countries?**

When a business first enters a foreign market, revenues may grow quickly. It is dangerous however to project these high initial growth rates into the future since these high initial growth rates can stabilize to normal levels after some time.

You should assess how committed the company’s management is to growing its foreign business – has the company deployed human resources to those markets, funded efforts to sustain growth, devised a strategy to compete with local market participants. Some basic questions about commitment to foreign markets include:

1. How long has the business been operating in the foreign market?
2. Why were specific foreign markets chosen?
3. How do the foreign markets in which the company operates compare to one another?
4. Is the business investing in R&D to adapt its products to the specific tastes of the customers?
5. Have regional managers been assigned and are these managers focused on their respective foreign markets?

Few products are so globally appealing that a business can market them around the world without adapting them. It is difficult for most businesses to sell the same product or service it sells in one market to all markets without adapting in some way.

Is revenue growth translating into profit growth? If a company does not provide adequate information, such as the operating profits earned from certain geographic regions, be cautious. This means that management is probably not generating excess profits in these foreign markets. You can read press releases and articles and speak with investor relations to obtain more insights.

What are the risks to a company’s foreign earnings? In other words, there is a risk that a business will lose money in a foreign market due to external factors such as:

1. Country specific risks – tax code, employment laws, government policies and regulations, etc… Resources for understanding country specific challenges include the World Bank (Doing Business Report), Business Monitor International’s (Country Risk Reports)
2. Currency risk – if the US dollar depreciates against the foreign currency, the margins of the business will decrease because each dollar is now worth less. Most businesses protect their exposure to changes in currencies by hedging. Therefore, assessing the company’s hedging strategy is critical in assessing currency risk or the lack thereof. When a business reinvests the revenue it earns in a foreign country back in the same currency, then it will now need to hedge – this is referred to as a natural hedge.

**Chapter 3 Understanding the Business – From the Customer Perspective**

Customers are the lifeblood of a business. The quality of a business is determined by the quality of its customers. The more you can understand a business from the customer’s perspective, the better position you will be in to value that business since satisfied customers are the best predictor of future earnings for a business.

One of the main pitfalls in researching a business is viewing the business from your own perspective, instead of from the customer’s perspective. What you personally like is irrelevant to investing. You need to determine why customers shop at a business or use its services and, most importantly, if they will continue to buy products and services from the business.

Customers’ behavior and preferences can give you insights into the sources of competitive advantage (or disadvantages) and subsequently monitor any threats to that advantage.

* **Who is the core customer of the business?**

What proportion of revenue is made by the core customer base and what proportion is this core customer base relative to the entire customer base? Speaking to customers, suppliers, customer demographic information services, and competitors is a helpful is gaining insights.

By identifying the core customer of a business, you will be able to gain an in-depth understanding of a business, and you will be in a position to carefully monitor customer trends. Does the company focus its attempts to cater to its core customers or does it attempt to reach out to too many types of customers.

* **Is the customer base concentrated or diversified?**

A business that earns its revenues from a diversified customer base has less risk than one with a concentrated customer base. A diversified customer base also has less influence on the price it can demand for a business’ products and services. If a business has revenues from one customer that exceeds 10% of total revenues, then the amount or revenues from each of these customers must be disclosed in the 10K as well as the name of the customer.

You should also be wary of trends in customer concentration.

* **Is it easy or difficult to convince customers to buy the products or services?**

Is a product or service being sold based on its merits or based on the ingenuity of the company’s salespeople? Companies that rely on high-pressure sales tactics typically do not have sustainable business models and are typically not good for customers.

* **What is the customer retention rate for the business?**

The customer retention rate (CRR) is the most common metric for tracking customer longevity. Companies with higher CRRs are more likely to succeed in the long run. The longer customers are retained, the more profitable the business becomes because it costs more to attain a new customer versus retain an old customer. Loyal customers also generate more predictable sales that can in turn improve profitability. Loyal customers also serve as advocates for the business’ products and services.

Businesses earning revenues through subscription models that do not report their CRR is a red flag. Monitoring how many customers are enrolled in a company’s loyalty program, if there is one, is a good way of estimating the company’s CRR. Loyalty programs are used to track customer behavior that in turn helps companies with improving sales, marketing and logistics.

Find out whether a business is making investments to retain customers. Historical articles and the company’s investor relations can be a good source for this insight. Are salespeople rewarded for customer retention?

Another factor to consider in context to CRR is whether a business is selective about the types of customers it will do business with. It is a good sign when a business is selective.

* **What are the signs a business is customer oriented?**

The importance of the customer experience (interaction between company and customer) is more important as the frequency of interaction increases (think about a gym versus a dishwasher maker). If you deem that customer experience is critical to say driving high CRR, then you have to assess whether the company has a customer-service-oriented culture – friendly, responsive, knowledgeable, solution focused, easy to deal with, etc… A company that takes advantage of its customers will eventually alienate them.

How does a company’s management maintain its connection with its customers? Is management engaged with ensuring good customer experience.

JD Powers customer satisfaction rankings and the American Customer Satisfaction Index are great resource for assessing a company’s overall customer experience rating.

* **What pain does the business alleviate for the customer?**

One of the most common questions venture capitalists ask a prospective start-up is “What pain does your business alleviate?”

* **To what degree is the customer dependent on the products or services from the business?**

Is a product or service a “need to have” or a “nice to have” for the customer? Necessity generates stability whereas discretionary generates volatility. A business whose customers depend on the product or service has a significant advantage. This assessment lands of a spectrum:

* Need to have
* Need to have, but not immediately
* Nice to have, but not critical

Do not make the assumption, however, that a discretionary business or industry will always lose sales in tough times. To analyze this risk properly you have to have a solid understanding of the business’ core customer base and the demographics and behavioral patterns associated with that base.

* **If the business disappeared tomorrow, what impact would this have on the customer base?**

Where else could customers go and why? Would it be easy to find alternatives in this scenario?