

THE INVESTMENT CHECKLIST

The Art of
In-Depth Research



MICHAEL SHEARN

The Investment Checklist

The Investment Checklist

THE ART OF IN-DEPTH RESEARCH

Michael Shearn



WILEY

John Wiley & Sons, Inc.

Copyright © 2012 by Michael Shearn. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at www.wiley.com/go/permissions.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993, or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data:

Shearn, Michael, 1975–

The investment checklist : the art of in-depth research / Michael Shearn.

p. cm.

Includes index.

ISBN 978-0-470-89185-8 (cloth); ISBN 978-1-118-14943-0 (ebk);

ISBN 978-1-118-14944-7 (ebk); ISBN 978-1-118-14945-4 (ebk)

1. Investment analysis. 2. Portfolio management. 3. Investments.

I. Title.

HG4529.S47 2011

332.63'2042—dc23

2011021446

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

*For my wonderful wife, loving parents,
and beautiful daughters.*

Contents

Preface		xi
Acknowledgments		xix
Chapter 1	How to Generate Investment Ideas	1
	How Investment Opportunities Are Created	1
	How to Filter Your Investment Ideas	14
	Using a Spreadsheet to Track Potential and Existing Holdings	19
Chapter 2	Understanding the Business—The Basics	21
	1. Do I want to spend a lot of time learning about this business?	22
	2. How would you evaluate this business if you were to become its CEO?	23
	3. Can you describe how the business operates, in your own words?	26
	4. How does the business make money?	28
	5. How has the business evolved over time?	29
	6. In what foreign markets does the business operate, and what are the risks of operating in these countries?	30
Chapter 3	Understanding the Business—from the Customer Perspective	39
	7. Who is the core customer of the business?	41
	8. Is the customer base concentrated or diversified?	42
	9. Is it easy or difficult to convince customers to buy the products or services?	43
	10. What is the customer retention rate for the business?	44
	11. What are the signs a business is customer oriented?	46
	12. What pain does the business alleviate for the customer?	49
	13. To What degree is the customer dependent on the products or services from the business?	49

	14. If the business disappeared tomorrow, what impact would this have on the customer base?	50
Chapter 4	Evaluating the Strengths and Weaknesses of a Business and Industry	53
	15. Does the business have a <i>sustainable</i> competitive advantage and what is its source?	54
	16. Does the business possess the ability to raise prices without losing customers?	68
	17. Does the business operate in a good or bad industry?	73
	18. How has the industry evolved over time?	77
	19. What is the competitive landscape, and how intense is the competition?	79
	20. What type of relationship does the business have with its suppliers?	89
Chapter 5	Measuring the Operating and Financial Health of the Business	97
	21. What are the fundamentals of the business?	98
	22. What are the operating metrics of the business that you need to monitor?	100
	23. What are the key risks the business faces?	105
	24. How does inflation affect the business?	111
	25. Is the business's balance sheet strong or weak?	113
	26. What is the return on invested capital for the business?	123
Chapter 6	Evaluating the Distribution of Earnings (Cash Flows)	137
	27. Are the accounting standards that management uses conservative or liberal?	138
	28. Does the business generate revenues that are recurring or from one-off transactions?	146
	29. To what degree is the business cyclical, countercyclical, or recession-resistant?	148
	30. To what degree does operating leverage impact the earnings of the business?	152
	31. How does working capital impact the cash flows of the business?	162
	32. Does the business have high or low capital-expenditure requirements?	167
Chapter 7	Assessing the Quality of Management—Background and Classification: Who Are They?	173
	33. What type of manager is leading the company?	176
	34. What are the effects on the business of bringing in outside management?	180

	35. Is the manager a lion or a hyena?	183
	36. How did the manager rise to lead the business?	186
	37. How are senior managers compensated, and how did they gain their ownership interest?	192
	38. Have the managers been buying or selling the stock?	202
Chapter 8	Assessing the Quality of Management—Competence: How Management Operates the Business	209
	39. Does the CEO manage the business to benefit all stakeholders?	210
	40. Does the management team improve its operations day-to-day or does it use a strategic plan to conduct its business?	213
	41. Do the CEO and CFO issue guidance regarding earnings?	219
	42. Is the business managed in a centralized or decentralized way?	222
	43. Does management value its employees?	225
	44. Does the management team know how to hire well?	239
	45. Does the management team focus on cutting unnecessary costs?	247
	46. Are the CEO and CFO disciplined in making capital allocation decisions?	248
	47. Do the CEO and CFO buy back stock opportunistically?	250
Chapter 9	Assessing the Quality of Management—Positive and Negative Traits	255
	48. Does the CEO love the money or the business?	256
	49. Can you identify a moment of integrity for the manager?	264
	50. Are managers clear and consistent in their communications and actions with stakeholders?	268
	51. Does management think independently and remain unswayed by what others in their industry are doing?	275
	52. Is the CEO self-promoting?	276
Chapter 10	Evaluating Growth Opportunities	281
	53. Does the business grow through mergers and acquisitions, or does it grow organically?	281
	54. What is the management team's motivation to grow the business?	282
	55. Has historical growth been profitable and will it continue?	283
	56. What are the future growth prospects for the business?	284
	57. Is the management team growing the business too quickly or at a steady pace?	296

Chapter 11	Evaluating Mergers & Acquisitions	305
	58. How does management make M&A decisions?	305
	59. Have past acquisitions been successful?	310
Appendix A	Building a Human Intelligence Network	323
	Evaluating Information Sources	324
	How to Locate Human Sources	324
	How to Contact Human Sources—and Get the Information You Want	328
	Create a Database of Your Interviews for Future Reference	329
Appendix B	How to Interview the Management Team	331
	Ask Open-Ended Questions	332
	Be Aware of the Danger of Face-to-Face Assessments of Managers	333
Appendix C	Your Investment Checklist	335
Notes		339
About the Author		351
Index		353

Preface

This book can help you make better investment decisions by helping you truly understand the companies you're investing in.

If you're like most investors, you make mistakes when you rush into an investment idea without doing the proper work to understand the value of a business. By rushing, you are essentially *betting on probabilities* that certain assumptions will work out, instead of basing your investment decision on *real analysis*.

Too often, investors buy stocks by relying on recommendations from other investors, or on hunches, or because of isolated facts they've heard or read about a business. When you make your purchase decisions on these factors and do not take the time to thoroughly understand the businesses you are buying, you're more prone to make investment mistakes. Your decision-making then becomes dangerous because you don't really know enough, and you're relying on *other people* and the information (or misinformation) they provide about a particular stock. Instead, your investment purchases should be based on understanding the value of a business through *in-depth research*. If you truly understand the value of a business, then you will be in a position to recognize investment opportunities and can more easily make buy or sell decisions.

Don't be daunted by the idea of in-depth research. This book makes the research *manageable* (more about that in a minute). Also, I'm sure you do research all the time before you spend your hard-earned money: For example, think about any major purchase you've made in your life—whether it's a house, or a car, or an expensive piece of jewelry or electronics. Before you spent all that money on whatever it was, you probably spent some time researching to make sure your money would be well spent. If you were buying a house, you (or your realtor) researched the price of other houses in that neighborhood and other amenities that would make that house desirable (e.g., the school system, ease of commuting, neighborhood

parks or pools or tennis courts or shopping, etc.). The more you know about your purchase, the more easily you will be able to recognize a good deal. The same is true when buying or selling a stock. The more you understand the dynamics of a business and the people operating it, the better the odds that you will be able to recognize a good deal on a business.

Many professional investors believe that in-depth research is a waste of time. To them, great investment decisions boil down to a few simple factors, such as an extremely low stock price. I used to subscribe to this theory myself, but over time, I discovered *I was wrong*. As I came to appreciate that the value of a business cannot be condensed into a few simple factors, I searched for books that would teach me how to value a business and invest intelligently in stocks. I was looking for a *practical* book instead of one that focused on broad concepts. In spite of the fact that there are hundreds of books written on the subject of investing, I honestly couldn't find *one* that truly helped me.

My instinct after failing to find a good investing framework was to over-research potential investments. I often ended up reading everything I could get my hands on about a potential investment. As a result, I subjected myself to information overload and was unable to recognize good information. I also kept repeating investment mistakes, such as paying too much for a business or partnering with the wrong management team.

So I set out to establish a systematic process to force me to think through my investment ideas more carefully and help me avoid repeating the same investment mistakes. Over the past 10 years, I began to use checklists of questions I needed to answer to make informed investment decisions—questions that would guide me in learning about a business's competitive position, customer positioning, and management strength. To come up with the questions, I studied the past mistakes I had made investing, and I read many books about the common mistakes made by investors and executives. I interviewed private equity managers, venture capitalists, entrepreneurs, chief executive officers (CEOs), hedge fund managers, mutual fund managers, and private investors to help me prepare a more comprehensive list of questions. During the stock market decline in 2008 and 2009, I made significant improvements to the checklists as the decline exposed weaknesses in my investment process.

As I used the checklists, I discovered that if I could answer the majority of the questions on the checklist, I could more easily value the business by minimizing the number of assumptions I was making about a business's future prospects. If I was unable to answer a question on the checklist (such as "are its managers honest?"), then I could identify the potential risks I was taking in an investment and the areas that I needed to spend more time researching.

My ultimate goal was to understand how well I understood an investment by the questions I was able to answer—and those I was *unable* to answer, which is often even more important. With some companies, I found that the more I read about them, the more questions I had about how the company operated—and I realized this was an indicator that I didn't really understand that business! For example, I spent a lot of time researching mortgage insurers in 2007 before the credit crisis began. Yet the more time I spent, the more questions I had. I never had enough information to be able to calculate a reasonable range of valuations for the businesses. I felt I was answering too many of the questions with *assumptions* rather than backing these assumptions with evidence. I therefore determined I was not in a position to value those businesses and I didn't invest in them. That red flag saved me a lot of money!

The result of all my research is this book, which describes the checklists I've used in my own investing over the past 10 years.

How This Book Can Help You

The Investment Checklist is for anyone who's investing in stocks, at any level—if you're just starting out and thinking about what you want to invest in, or if you already have a portfolio (of any size) that you want to manage better and watch your money grow (after all, no-one wants to watch their investments *lose* money, shrink, or disappear altogether!). That said, this book *isn't* for stock traders (aka *day traders*) or people who invest only for short-term gains.

Instead, this book is for anyone who wants to learn how to *value* a business and invest for the long term: I wrote it to help you learn what you need to know about specific companies you're considering investing in, and to help you evaluate whether or not those companies are *worth* investing in.

Before you read any further, consider these questions about *you* and your approach to investing (and be honest): You're not sharing these answers with anyone else!:

- Do you check stock prices frequently?
- Do falling stock prices make your stomach churn?
- Do you react quickly to positive or negative news announcements about the companies whose stock you own?
- Do you ever feel you're under time pressure to make buy or sell decisions?
- Do you have high portfolio turnover? Are you buying and selling shares often?
- Do you feel you need to defend your investments when others challenge you?

If you answered “yes” to *any* of the above questions, this book can help you make better investment decisions, by helping you research more effectively so you'll truly understand how a business operates and is managed. As I developed my checklists, the benefits of creating a concise and easy-to-use framework became apparent. In short, the exercise of going through *The Investment Checklist* lowers your risk by increasing your knowledge of a business. Here's how the checklists in this book can help you:

- *The checklist will help you filter out the noise and instead focus on information that is most important and relevant.* There is an unending stream of information available; don't get bogged down in information overload, as I did when I first started investing. This book tells you what information you really need and where to find it.
- *The majority of the questions can be answered by information that is relatively easy to find.* You can find most of the information to answer the checklist questions in publicly available Securities and Exchange Commission (SEC) documents or articles written about management and the business.
- *The questions should help you understand the business as if you're the business owner and help move you away from thinking of stocks as pieces of paper.* The checklist questions force you to think about the fundamentals of the business rather than just its stock price. Worrying about things such as fluctuations in

the stock market (which are outside your control anyway!) is a waste of time. Instead, you will be able to identify the main factors that drive the value of the business, most of the risks the business can encounter, and the things that can go wrong.

- *The checklist will help you take a long-term view of your investments.* Most people tend to remember recent events more easily. The checklist requires that you answer questions using a long time span, which helps protect you from overvaluing more recent pieces of information. Researching a business over a long period of time allows us to sort through things rationally and puts us in a position to better interpret information.
- *The checklist is useful for compiling information that goes against your investment thesis.* It is human nature to overweight information that supports your investment thesis and underweight information that is contrary to your investment thesis. The checklist questions help you ensure you're accepting (or at least recognizing) divergent facts about the business.
- *The checklist will help you improve sell decisions.* Knowing when to sell an investment is one of the most difficult decisions you have to make. Most sell decisions are based on judgment, feel, or instinct. The checklist helps you learn when to sell by helping you identify when the fundamentals of a business, such as the quality of the business or management team, begin to change.

How This Book Is Organized

The three most common investing mistakes relate to the price you pay, the management team you essentially join when you invest in a company, and your failure to understand the future economics of the business you're considering investing in. The questions in this book can help you minimize these mistakes by helping you gain a deeper understanding of how a business operates:

- Chapter 1 outlines a search strategy that will improve your odds of finding investment ideas that are worth researching further.
- Chapter 2 helps you understand the basics of a business: What it does, how it earns money, how it evolved over time, and in what geographic locations it earns its money.

- Chapter 3 demonstrates the importance of understanding the business from the customer's perspective rather than your own. These insights will help you learn how important a business is to the customers it serves.
- Chapter 4 helps you evaluate the strengths and weaknesses of a business. These are the questions that will help you evaluate whether or not a business has a sustainable competitive advantage, the competitive landscape, and the industry it operates in.
- Chapter 5 helps you understand the operational and financial health of a business. You'll look at key risks facing the business, how inflation affects it, and whether its balance sheet is weak or strong.
- Chapter 6 looks at the distribution of earnings (cash flow) of a business. You'll learn how to assess whether the company's accounting practices are conservative or liberal (so you can avoid a company like, for example, the now-defunct Enron), the type of revenue it generates, whether the company makes money consistently or in cycles, and whether or not it's resistant to recessions.
- Chapter 7 is the first of three chapters that show you how to understand the quality of the management team. You'll look at what type of manager they are, how they rose to lead the business, how they are compensated, and other background information.
- Chapter 8 helps you gain insight into the competence of a company's senior management. You'll look at how they handle daily operations as well as long-term strategy, how they treat employees, and how they think about costs.
- Chapter 9 helps you assess the management of a company by looking at their positive—and negative—traits: How they think, whether they're self-promoting, and other critical factors. Remember, when you buy stock in a company, you're essentially going into business with the managers who run that company, so you want to know as much about them as you can!
- Chapter 10 demonstrates how you can evaluate the future growth opportunities of a business. You'll look at whether it's growing organically or by merging with or acquiring other companies, whether historical growth has been profitable,

and how quickly it's growing and whether management is growing in a disciplined way.

- Finally, Chapter 11 looks specifically at mergers and acquisitions, to determine whether those completed in the past have been successful and how management makes the decision to merge with or acquire another company.

Each chapter offers countless examples of businesses I've researched, considered investing in, actually invested in, or decided not to invest in. These examples tell you in detail how my checklist helped me make investment decisions, and they'll show you how you can make better investment decisions for your own portfolio. In addition, each chapter ends with "Key Points to Keep in Mind," so you can zero in on the critical factors in each set of questions.

Now, let's get started by learning how to generate investment ideas!

Acknowledgments

This book would not have been written without the encouragement and help of Judd Kahn and Bill Falloon who championed this book from the earliest proposal. No one deserves more thanks than my partner Ann Webb. Her willingness to make everything she touches a success is forever appreciated. Ruth Mills simplified the book-writing process for me and I can't imagine finishing this book without her. Dr. Sandy Leeds was a true devil's advocate. Those who have Sandy in their corner, both students and friends, are very fortunate. My friend Jeff "Falcon" Sokol helped ground the book and at the earliest stages attempted to convince me not to endeavor in this project. As such, all critics need to talk to Jeff about improving his powers of persuasion. I want to thank my mentor and intellectual coach John "Chico" Newman who always provides practical advice.

I would also like to thank the following for their contributions to the book: Bob Aylward, Ciccio Azzolini, Ron Baron, Peter Bevelin, Dr. Paul Bobrowski, Jean-Philippe Bouchard, Dr. John Delaney, Pat Dorsey, Matt Dreith, Ryan Floyd, Meg Freeborn, Ben Gaddis, Francesco Gagliardi, Dave and Sherry Gold, Bob Graham, Todd Green, David Hampton, Norman Hecht, Casey Hoffman, K.K., Paul Larson, Brad Leonard, Steve Lister, Chris Lozano, John Mackey, Denise Mayorga, Bob Miles, Vincent Nordhaus, Francois Rochon, Robert Silberman, Paul Sonkin, Jim Sud, Seng Hock Tan, Lee Valkenaar, and Matthew Weiss.

On a personal note, a heartfelt thank you to the most important people in my life. My parents have never wavered in their support of my ventures. Their patience allowed me to find my own path. Most of all I thank my wife for her steadfast love, support, and guidance. And I want to give a special dedication to my beautiful girls who have forever changed my life in the most wonderful way.

CHAPTER 1

How to Generate Investment Ideas

There are many ways you can generate investment ideas, some qualitative, some quantitative. *Quantitative* methods include looking at specific financial or operating metrics, whereas *qualitative* methods rely on more subjective characteristics, such as management strength, corporate culture, or competitive advantages. Whether you are running a complicated stock screen or simply getting ideas from other investors, all methods have their own advantages, limitations, and risks. Ultimately, the best method of generating ideas for you is the one that gives you the largest number of opportunities.

This chapter explores why stocks become undervalued, how to generate investment ideas, how to filter these ideas, and how to keep track of them. These steps are critical to creating a pool of stock ideas.

How Investment Opportunities Are Created

You can't manufacture investment opportunities. Instead, you need to be patient, and you have to be ready for the right opportunities. It is important to understand that good investment ideas are rare, and consistent success in the stock market is elusive. Those investors who believe that they can make money year after year in the stock market are setting themselves up for disappointment. Most investors are far too optimistic: They often think they've found great ideas when they haven't.

In contrast, investors with the best long-term track records have made most of their money with just a handful of investment ideas. For example, Warren Buffett states that his investment success is due to fewer than 20 ideas, such as the *Washington Post* newspaper,

Coca-Cola, and GEICO. In short, you need to mentally prepare yourself in advance with the idea that you will not have many outstanding investments in your lifetime. 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. There have been several recent examples: the Asian financial crisis of 1997 to 1998, the Internet bubble ending in 2000, and the recession starting in 2007. There were many buying opportunities in 2008 when the S&P 500 dropped 36 percent. This was caused by forced selling. The market sell-off was exacerbated by the indiscriminate selling of stocks by money managers who were forced to sell stocks to fund client redemptions. Even if these money managers knew these stocks were undervalued, they had no choice but to sell. This forced selling created artificially low prices—which created a rare opportunity for investors.

Other kinds of forced selling include situations when stocks are thrown out of an index because they no longer meet the minimum standards to remain in an index. Many investment managers who exclusively invest in stocks found in a particular index (such as the S&P 500) are forced to sell when the stock moves out of the index. Spin-offs (where a business divests a subsidiary) create a similar situation when the business that is spun off does not fit the investing criteria of an investment manager. Forced selling decreases prices—which creates opportunities.

Besides broad market sell-offs that create forced selling, the stock market has a way of magnifying different types of business and industry-wide risk that cause the stock prices of businesses to drop. To learn which area of the stock market is in greatest distress, look for those areas where capital is scarce. Scarcity of capital creates less competition for assets, which decreases prices. Ask yourself, *what areas of the stock market are investors fleeing, and why?*

You may want to begin by looking at the percentage change in prices of certain industries found in common indices such as the materials, energy, or financials subset of the S&P Composite 1500. For example, the price performance for components of the S&P Composite 1500 from April 23, 2010 to June 7, 2010 showed that:

- Materials were down 18 percent
- Energy was down 17 percent
- Utilities were down 9 percent

With that information, you might start researching the materials industry, looking for stocks that have significantly dropped in price. Ideally, you want to identify those stocks where the baby has been thrown out with the bathwater—and then rescue that baby!

Most stock price drops are due to some type of uncertainty about the business, and there are many possible reasons:

- Litigation fears
- Accounting irregularities
- Accusations of fraud
- Health concerns (such as swine flu)
- Execution problems due to a flawed strategy
- Management concerns
- Executive departures
- Government intervention or regulation
- Loss of a customer
- Technological changes
- Credit rating downgrades
- Competitor announcements
- Or a myriad of other reasons

In most of these cases, investors automatically assume the worst-case scenario and tend to sell stocks first and ask questions later. Once the reality starts to set in that the ultimate outcome will not be as bad as expected, then stock prices adjust and typically rise. Ideally, you want to identify those areas where the outlook is most pessimistic and *identify whether the sources of pessimism are temporary or permanent*. Let's look at an example.

Case Study: Investors' Pessimism about Heartland Payment Systems Proved Unfounded

In 2009, Heartland Payment Systems found itself in what appeared to be a disastrous scenario. Heartland helps small and mid-sized merchants with credit-card transactions, providing the physical card machine and payment-processing services that enable customers to use credit and debit cards in retail stores. In 2008, computer hackers installed spyware on Heartland's network and had gained access to the systems that process Visa, MasterCard, Discover, and American Express transactions.

After discovering the problem, Heartland announced details concerning the breach, including the number of months the

spyware might have gathered card numbers and the number of transactions that the company usually processed. Framing it as potentially the largest data breach in history, the *New York Times* noted that 600 million or more card accounts were vulnerable, and quoted a data security analyst who said that there could be as much as \$500 million in losses and other expenses if you added it all up. Early estimates were that Heartland would have to pay \$2 per card for MC/Visa to reissue each affected card. The result? Investors quickly sold the stock. The price plummeted from \$18 per share before the breach was announced (on January 6, 2009) to as low as \$3.78 per share on March 9, 2009.

However, other investors with a solid base of research on the company and industry knew several things that helped them take advantage of this situation:

- First, they focused on Heartland's transaction count of 100 million transactions per month, and they recognized that not all of those would be from unique accounts. People tend to go the same places more than once. Later, more conservative estimates of stolen cards emerged at about 140 million cards, instead of 600 million.
- Second, there was publicly available information about a similar case involving retailers TJ Maxx and Marshalls that had been settled recently. In that case, the average settlement per account to the issuing banks to replace cards was about 70¢ per card.

In 2010, Heartland agreed to pay MasterCard, Visa, and American Express \$105 million—not the \$500 million that was originally estimated by news sources. This amount, which averaged 81¢ per card, was similar to the recent TJ Maxx and Marshalls case. More important for investors was the fact that this was a far cry from the first potential loss estimates. Investors who already held stock in Heartland shouldn't have immediately sold the stock on the news. They would have been *rewarded* if they had purchased *more* of the stock to decrease their cost basis. Also, investors who didn't already own Heartland stock should have bought at this time because this one-time event was nowhere near as devastating as the sources in the press made it out to be. After investors realized that the liability from the breach was lower than they anticipated, the stock price

recovered to more than \$13 per share several months later (by the end of 2010).

In sum, if you had purchased the stock after the breach was announced, *you could have tripled your investment!*

Be Wary of Exciting New Trends that Turn out to Be Fads

You must also learn to identify those areas of the stock market that are benefiting from abundant sources of capital, which drives up prices, so you can be careful investing in them. Wall Street is good at pitching stories, and investors tend to get excited by what they believe is an important new trend. However, many of these exciting major trends turn out to be fads that are based on speculation, rather than fundamentals. Let's look at a couple of examples.

In the 1960s, investors bid up the stocks of conglomerates that were increasing their earnings through acquisitions. Businesses such as James Ling's LTV (Ling-Temco-Vought), bought unrelated businesses to increase and diversify their revenue streams. Growing quickly, they used their high stock prices to purchase other businesses. LTV acquired company after company, growing from the 204th largest industrial company in 1965 to the 14th largest in 1969—only four years later!

Yet by 1970, under the pressure of enormous debt, antitrust threat, and a generally bearish market, LTV's stock had plummeted, as did the stock of several of the other recently ballooned conglomerates. From a high in 1968 of \$136 per share to a 1970s low of \$7 per share, LTV ended up selling many of its acquisitions at clearance prices.¹

The 1990s gave us another kind of speculative boom, what we now call the Internet bubble. Technology stocks provided rates of return that dwarfed their actual growth or profits (if they had any profit at all). For example, computer manufacturer and services company Sun Microsystems was once valued as high as 10 times revenues when its stock traded for \$64 per share. CEO Scott McNealy recalls that heady period: "At 10 times revenues, to give you a 10-year payback, I have to pay you 100 percent of revenues for 10 straight years in dividends." McNealy noted that his assumptions include a few major obstacles such as getting shareholder approval for such a plan and not paying any expenses or taxes. Furthermore, McNealy noted that Sun Microsystems would also have to maintain

its revenue run rate without investing in any R&D. McNealy asked, “Now, having done that, would any of you like to buy my stock at \$64? Do you realize how ridiculous those basic assumptions are?”²

How to Spot Investment Bubbles

To understand where current bubbles exist, ask, “Where is a lot of money being made very quickly?” Look at the *Forbes* magazine list of billionaires. What industries are the new billionaires coming from? For example, in the early 1980s, the *Forbes* list was populated mainly by individuals in the oil and gas industry. Also, monitor initial public offerings (IPOs) coming to market. Are the IPOs that are quickly rising in price concentrated in a certain industry, as Internet stocks were during the technology boom of 1998 to 2000?

When capital is abundant, it searches for other similar businesses to duplicate success. The IPOs of technology businesses caused many other technology businesses to be formed and seek to go public. Here are a few signs of a bubble:

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

One of the lessons from the 1980s real estate boom/bust was that there was a grace period in which everybody had money in their pockets and they did not have to worry about whether tenants would occupy the buildings or whether the assumptions about future cash flows were going to be proven correct. Buildings were built on a speculative basis, as lenders were in essence throwing money at developers to build new projects and did not worry if the builders had tenants to occupy these buildings. Eventually, there was an oversupply of real estate, which caused prices for real estate to drop. Lenders and developers found themselves with many empty properties, and there were many bankruptcies during this period. This just goes to show that areas where there is an abundance of capital are usually poor hunting grounds for great investments. Investors who got caught up in the hype of the 1980s

real estate boom or technology bubble of the late 1990s ultimately ended up losing most of their capital.

Now that you know more about how to generally look for investment ideas, the following sections of this chapter describe a few more formalized ways to begin looking for investment ideas.

Using Stock Screens

A stock screen is a tool investors use to filter stocks, using pre-selected criteria. For example, if you're an investor looking for cheap stocks, you could enter a set of filters such as: "companies that have enterprise value to earnings before interest, taxes, depreciation, and amortization (EBITDA) ratios of less than five times that also have market capitalizations over \$100 million."

This produces a list of businesses that fit the limits you've just set.

There are many different types of screening tools available. Services range from free services to those with high-end fees, with features and coverage varying by service. The higher-fee services cover a greater number of businesses, including microcap stocks and international stocks, and they often come bundled with a range of analytical tools that can help you further refine searches, such as "search for businesses with more than \$100 million in revenues that have CEOs over the age of 60."

One of the main limitations of stock screens is that they use Generally Accepted Accounting Principles (GAAP) accounting numbers, which rarely present a realistic financial picture of a business. For example, if you are looking at a multiple of last year's earnings, this can be misleading if the company reported a big loss in the prior year. Investors often need to adjust GAAP earnings to understand the real earnings of a business.

For example, in 2006 and 2007, the average trailing 12-month price/earnings ratio (P/E) for retailer 99 Cent Only Stores was more than 90 times.³ After adjusting the earnings for special charges 99 Cent Only Stores took in those two years, I learned that the adjusted P/E was closer to 12 times rather than the 90 times being reported.

On a standard stock screen, many of my best investments showed up as having a P/E ratio of more than 50 times because GAAP accounted for such factors as restructuring costs that reduced earnings. After I made GAAP adjustments, I found that these ostensibly high

price-to-earnings-ratio businesses were really trading at only five times earnings, not 50. Had I relied exclusively on stock screens, I would have missed many of my best investments.

For example, when I was researching the stock of Four Seasons Hotels, which had dropped in price after the September 11 terrorist attacks, its P/E ratio was 85 times earnings. Four Seasons had just taken several restructuring charges, which reduced the earnings of the business. After adjusting the earnings of the business for these restructuring charges (which were due to GAAP standards rather than actual cash charges), the P/E ratio was closer to 10 times earnings. Had my firm relied on a stock screen, we would have never found this investment, which doubled in price in a short period of time.

Keeping an Eye on New-Lows Lists

Newspapers and websites can provide other idea sources like new-lows listings. For example, the online site for the *Wall Street Journal* offers daily and historical new-lows listing of U.S. stocks—that is, those reaching new 52-week price lows on the NYSE, AMEX, and NASDAQ.

Also, Value Line regularly publishes stock listings such as those that have:

- The widest discounts from book value
- The greatest percentage price changes over the previous 13 weeks
- High 3- to 5-year price appreciation potential
- Current P/E multiples and price-to-net working capital ratios that are in the bottom quartile of the Value Line universe

Paul Sonkin, manager of the Hummingbird Value Fund (a micro-cap fund), uses stock screens and new-lows lists, but he believes these tools are misused by investors 99 percent of the time. According to Sonkin, “. . . a lot of investors will put together a screen of low price-to-book or low price-to-earnings stocks, but usually 90 percent of the companies on the screen are cheap for a good reason. Many stay on these lists for a long time.”⁴ Sonkin believes the proper way to use a screen or new-lows list is to run them on a weekly basis and look for *new* companies that appear on the list. This way, you are able to separate the companies that deserve to be there from those that may only be suffering from a temporary problem.