Getting a Fair Shot

Individual investors may be lacking the tools and sophistication of institutional players, but those who take the trouble to learn could still come out top. *By Rohit Gupta*

Efficient market theory and the multitude of highly paid analysts would appear to make individual stock picking a "losers game". However, there is an alternate view that provides small individual investors - those willing to do their homework – an advantage.

Individual Investors:

1. Mutual Funds are not serving the best interests of investors.	2. Bias in analyst industry: Most analysts only cover one industry.
• As mutual fund fees are paid as percentage of asset under management (AUM), the overiding drive amongst fund managers is for asset size. This leads to increased marketing, which will also push to bring out new niche funds. Both, negatively impact consumers via higher expenses and increased volatility.	• As an investor, you do not need to restrict yourself to any one industry, but choose those offering highest potential returns, across Industries.

3. Diversification only addresses a part of total risk- does not address market risk (risk of total market going up or down).

- Beyond # 6 or 8 stocks (in different industries), overall market risk is not eliminated by merely adding more stocks. In a practical sense, fund managers add stocks more driven by fund size and legal considerations, than merely stock considerations or diversification.

Individual investors are not constrained similarly and can limit to few optimal picks.

Investment Philosophy	Investment Strategy
• Rule #1: Never lose money. • Rule #2: Never forget Rule #1. • Risk is not the same as volatility. • Understand the difference between price and value. • Make sure that you have a margin of safety.	1. Focus on companies with strong Economic Moat. 2. Buy at a discount to Fair Value. 3. Know when to sell.

Investment 101:

When you buy a company's stock, you are in effect buying its cash flows based on future profits. The key to investing is not how much a company/industry will impact society or how much it will grow - but its ability to make sustainable profits.

Avoid the mistake of confusing a great company with a great investment – the two can be very different.

Investment Philosophy:

1. Rule #1: Never lose money. Rule #2: Never forget Rule #1.

Look down, not up. If you don't loose money, most of the other alternatives look good.

- Large losses are very difficult to recover from, and must be avoided. While a 10% loss, will require a 11% gain to recover, a 50% loss, requires a 100% gain to recover (and a 75% loss - a 300% gain!).

2. Risk is not the same as volatility: Higher risk does not mean higher reward.

- The standard beta definition (price volatility of a particular stock relative to the market as a whole) - measures risk in an erroneous way – equating volatility with risk. A measure of relative short term volatility vs. longer term potential for loss.
- As investors, one is not concerned with volatility, per se, but the possibility of losing money (or not achieving a satisfactory return). A stock that has fallen from RM30 to RM10 is considered more risky than one that has fallen from RM12 to RM10, even though the latter is available at a greater discount (and the expectation of reward maybe greater!).
- Sometimes risk and reward are correlated in a positive fashion e.g. – a higher payout for undertaking a risky venture. The exact opposite is true with value investing - the greater the potential for reward, the less risk there is.

"In the short run, prices can differ widely from value, but in the long run, price and value tend to converge. You don't need to concern yourself with market psychology, price charts, or anything else not related to the intrinsic value of the company."

3. Understand the difference between price and value.

- "Price is what you pay. Value is what you get." The basic concept is that an asset has an underlying value or "intrinsic value" that is separate from its price. A business is valuable whether you intend to sell it or not because it generates cash flows.

4. In the short run, the market is a voting machine, but in the long run, it is a weighing machine.

- In the short run, prices can differ widely from value, but in the long run, price and value tend to converge. You don't need to concern yourself with market psychology, price charts, or anything else not related to the intrinsic value of the company.

5. Make sure that you have a margin of safety.

- Stock Market Returns are a combination of (i) investment returns (Earnings growth + Dividends), and (ii) speculative returns (changes in P/E ratio).
- As it is impossible to know future P/E ratio - valuation is critical. Return is dependent on the Price you buy at. Buying at lower P/E lowers risk by allowing for a "margin of error" as well as opportunity to benefit from growth.

Investment Strategy:

1. Look at stocks as a business: In buying a stock, you are buying future cash flows. Focus on return on capital. As markets are very competitive, and predicting the future is very difficult, focus on businesses that have a long term advantage. An economic moat.

- Moats are not based on (i) Products, (ii) Market share, (iii) Execution, or (iv) Management. But, (i) Intangible Assets (brand, patents, regulatory licenses), (ii) High switching costs, (iii) Network economics, and (iv) Cost advantages (location, process or scale). Do not fall in love with the product, but where model allows, long term pricing power or cost advantage.

- Key financial consideration include free cash flow, and return on capital.

2. Determine the true (intrinsic) value of a business and buy stocks in these companies when they go on sale (Better to buy a great business at a fair price, than a fair business at a great price):

- Valuation methods include (i) Price multiples, (ii) Yield, (iii) Intrinsic value.
- Common Price multiples include – (a) Price-to-Sales (P/S), (b) Price-to-Book (P/B), and (iii) Price-to-Earnings (P/E) ratio. While P/E is most common, P/S and P/B are also appropriate where earnings are temporarily depressed, and for specific industries (banks). It is however, difficult to compare across industries, as we must also factor in the growth rate and return on capital.
- Intrinsic Value – computed as present value of future cash flows. Cash flows are projected on growth assumptions, and Discount Rate (9%– 14%) factors in risk premium. As such, this is a measure of value vs price, and also allows a better understanding of underlying assumptions and their impact.

3. Have a margin of safety.

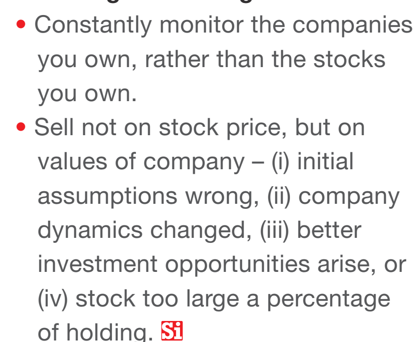
- A margin of safety exists when the purchase price of an investment is lower than the intrinsic value. Not only does this provides a strong protection against downside risk, but also provides a good chance at earning high returns.

- Look at discount of 25% – 50%, depending on width and depth of economic moat.

- Use a market's fluctuations to your advantage. However, good companies are not always available at a discount. You must do your home-work and have the courage to take a stance that's different from the crowd.

4. Make a profit by selling your business at above its intrinsic value. The hardest part of investing is knowing when to sell.

- Constantly monitor the companies you own, rather than the stocks you own.
- Sell not on stock price, but on values of company – (i) initial assumptions wrong, (ii) company dynamics changed, (iii) better investment opportunities arise, or (iv) stock too large a percentage of holding. Si



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