

EQUITY SELECTION

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ABSTRACT

This essay is meant to give a brief but useful overview of how we think about investment selection—our philosophy and process. It is written to be as understandable as possible for non-investment professionals. I use a minimal number of industry abbreviations and, where necessary, have included “Useful” text boxes for abbreviations used. My goal is for readers to come away with meaningful insights and a greater familiarity with sound investment methodology.

Sector SPDR ETF’s tagline is “Why invest in a single stock when you can own the entire sector?” We would retort, *why own the entire sector when you can own wonderful companies at decent prices (or decent companies at wonderful prices)*. This phrase captures our philosophy in a nutshell. We believe buying assets at the right price relative to value is the secret. To be successful requires competence, patience, and proper thinking. The trait that so few seem to possess; the one that’s so difficult to maintain—is the capacity to zig when everyone else is zagging. And to zig when everyone else is zagging, an investor must have:

- a) a deep understanding of and unshakable confidence in the methods,
- b) a process for consistent implementation of those methods which is not biased by the [internal or external] “talking heads”,
- c) and a system in which one is forced to stay the course when seemingly all others—*the market*—either (1) want to buy the most expensive securities—*indicating greed, euphoria, fear of missing out*—OR (2) want to sell everything and head for the hills—*indicating fear and panic*.

METHODS (a) are the analytical and thinking tools to make decisions. PROCESS (b) is the framework for *how* the tools are used. The SYSTEMS (c) are the rules to ensure we go against the human tendency to follow the crowd or lose our heads (and shirts).

The key to long-term superior results is mastering (a), (b), and (c). We try to go in each day with genuine humility and respect for markets, because if we don’t the market will do it for us. Putting all of these together is no easy task. Doing it consistently is even harder. When done well, the results are very rewarding.

As Charlie Munger puts it, “*anyone who tries to tell you it’s easy is stupid.*”

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Let's quickly define "long-term results." I used to say five years was needed (three years minimum) to accurately assess an investment manager. [Jim O'Shaughnessy has convinced me otherwise](#). His team analyzed legendary investment managers over rolling one- to ten-year periods. They found that over a career, all respectable investment managers will at some point experience underperformance over **at least** a three-year rolling period. Yet results among these top managers (driven by a systematic value-oriented approach) were virtually always superior over a 5-10 year rolling period, with the probability of outperformance increasing with the number of years.

Price and Return

As a rule of thumb, when prices rise expected returns decrease and as prices decline expected returns increase. This isn't exactly true, but it's close. More accurately, there is an inverse relationship between valuation and expected returns. When one is high, the other is low.

Expected returns increase (or decrease) as prices fall (or rise) relative to intrinsic value.

Say a stock was trading at \$15 dollars yesterday and we had an estimated intrinsic value range of \$17.50-19.00 per share. Let us assume a negative catalyst occurred today and induced an emotional selloff, sending the stock down 20% to \$12.00.¹ We'll assume our discount rate and growth assumptions are reduced such that our intrinsic value estimate is now be \$15.50-18.00, compared to \$17.50-19.00 yesterday.

The first scenario provides a 16.7% to 26.7% from the lower to upper estimate range. In the second scenario, after the selloff, we calculate a 29% return on the lower end and 50% on the upper.

This simple example explains a very useful phenomenon. The opportunity exists because falling prices look dangerous causing others to flee. Fear is the natural reaction to danger. Most people naturally run from this type of situation. Yet where was the danger greater? Before the stock dropped 20%, or after?

In addition to fear, the problem is compounded by a lack of confidence and/or ability to assess value. This is a problem for most, but an opportunity for us.

Common Abbreviations:

P/E : Stock Price / Earnings per Share

P/B : Price / Book Value per Share

P/FCF : Price / Free Cash Flow per Share

V(e) : Intrinsic Value Estimate

g : a company's growth rate assumptions for revenue, earnings, and cash flow

k : the required return used to discount future cash flows to today's PV

Valuation and Fortune-telling

The conventional method of assessing "value" stocks is to look at multiples. Growth stocks are said to be those that have high P/E, P/B, and P/FCF. Value stocks, on the other hand, are those with low P/E, P/B, and P/FCF. This is possibly the worst way to correctly value stocks because it attempts to boil something complex down to a single variable.

¹ Large selloffs usually occur for legitimate reasons—because either (1) the company misses earnings estimates, cuts a dividend, and/or revises guidance down; or (2) something or someone engenders a geopolitical or economic fear, e.g. European debt crisis, Chinese currency devaluation, oil inventories come in much lower than expected. Some portion of the time a selloff quickly moves from legitimate to emotional as investors begin to sell out of fear that the price will continue to fall.

Useful valuation estimates—aka “ $V(e)$ ”—are much more involved than simply evaluating multiples. They require a deeper understanding of both fundamental criteria (e.g. financial statements), quantitative calculations (e.g. discounting cash flows), and combining the two to assess, for instance, the probability a company’s margins will be x percent in y years. The most important aspects of a *single* $V(e)$ are a company’s [revenue, earnings, capex, FCF, etc.] **growth assumptions (g)**; and the **required return (k)** used to discount cash flows to their present value. I highlight *single* because it should be noted that a single run $V(e)$ will always be highly sensitive to growth and discount rate assumptions.

Unfortunately(?), we cannot tell the future. Hence, we cannot not actually know what a company’s future growth rates will be. This tends to be an area of weakness for many investors. They spend far too much time trying to assess economic, industry, and company-specific conditions. We find ourselves not too infrequently needing to be reminded not to overemphasize predictions, forecasts, and recent “important” events. Aside from it being an extremely complex task (there are too many variables to accurately assess), *if* one were to get it right for the moment, conditions change so quickly that it would need to be revised and reexamined numerous times per year. This is also why many in the academic and elite communities lean to passive investing—because optimal solutions can rarely be precisely known at a given moment. This uncertainty causes confusion and frustration because the focus is on being right or knowing the answers. Rather, the focus should be on probabilities, base rates, and asymmetric risk/reward.

The starting point for valuing companies is (1) making multiple assumptions about future growth g , (2) assessing the risk and applying a discount rate k to future cash flows, and (3) using the discount rate to compute the present value of future years.

Given the sensitivity of the $V(e)$ to g and k , one should be extremely cautious in becoming too confident in, and therefore relying on, g and k as the main premise for one’s confidence in the $V(e)$. (Unless, that is, they enjoy the gift of a very specific type of fortunetelling.) One must always deal in ranges rather than specifics. Or as Buffett and Munger say, “*We’d rather be approximately right than precisely wrong.*”

We believe the best way to assess $V(e)$ is with a range of reasonable growth and discount rates, and assigned probabilities to each sub-range (e.g. where $g = 10.0-14.9\%$, $p = .25$; where $g = 7.0-9.9\%$, $p = .30$; where $k = 12.5\%-15.0\%$, $p = .40$;...). In this framework, we are able to assess the sensitivity of $V(e)$ across many distinct scenarios. The aggregate of these scenarios (typically 25-100) create a **scenario-weighted $V(e)$** and are further broken down into their **average, median, and n^{th} percentile**. Then the final step is the determination of a reasonable $V(e)$ range.

We cannot be right with every pick and would prefer not to drive ourselves mad by believing otherwise. Rather, we want:

- (1) ... to know our probability of being right or wrong—and the magnitude of gains (when right) and losses (when wrong). That is, we want to know how often we’re wrong and how by how much. This alone puts on far along the track towards superior long-term results.
- (2) ...to continuously improve our gain/loss severity. That is, we want the average winner to be much more than the average loser.

To do well, stop thinking you have to be right [all the time]

Paradoxically, *one can be wrong more often than right* and still do well by earning much higher returns on winners than losers. A friend of mine takes this notion to the extreme by trying to win very big on only about 1/10th of his holdings. He may lose 5% on average across 45 of his 50 holdings, but if the remaining 5 earn, on average, 150% his net return is around 10%. Essentially, he is fine with—nay, *he embraces!*—“losing” 90% of the time because the minority of winners possess such an *asymmetric* payoff.²

While we do not try to lose 90% of the time, the foremost principle of investing is to embrace being wrong a certain percent of the time. If you focus only on the outcome... if you focus only on trying to be right all the time... if you confuse the signal and the noise... you will do poorly in investing.

Outcomes are [eventually] the result of quality decisions. Decisions should be judged, but they can only be judged on the information available at the time the decision was made, and the process/system used. Investment success requires a systematic process which helps identify errors and improve decision-making. One must know how often they are wrong and, to the greatest extent possible, why. And the only way to know why is to understand value.

² This is the principle on which tail-hedging is based. If you are unfamiliar and would like to learn more, we've created an educational page at www.canterburytg.com/risk-return.