

Long-Term Equity Strategy Considerations

Over the years Martin Capital Management (MCM) has made enormous strides in our aim to build first-class equity research and analysis expertise. Four years ago MCM housed two professionals whose collective credentials included an MBA and two Chartered Financial Analyst¹ (CFA) designations. Today, the professional staff consists of six professionals who collectively have or are approaching completion of five CFA's, three M.B.A.'s, a Masters in Accountancy, and a Ph.D. The *minimum* educational requirement for the professional staff is the CFA designation and a master's degree in a business-related field—a minimum five years of post-undergraduate work.

More importantly, we have emphatically targeted our added resources and aptitude toward the analysis of businesses that are *truly* worthy of long-term investment consideration. Our experience in working for and with larger institutions, which continually seem to squander precious talent and resources on either speculative businesses or those with poor economics, long ago influenced our view on the proper utilization of investment talent. Indeed, our own experience (direct and vicarious) has solidified our views regarding equity strategy.

Narrowing the Universe: The Use of Filters

The CompuStat database lists roughly 4,100 publicly-traded businesses in this country with equity market values that exceed \$75 million. Even for the largest institutions, maintaining a list of investment alternatives that number in the thousands is an

¹ A *minimum* three-year post-undergraduate program that is widely acknowledged to be the highest professional accreditation in the investment management industry.

unmanageable situation. As a result, some mechanism or process is needed to manage the number of stocks that can be legitimately scrutinized and analyzed. In certain respects, the process is not altogether different than someone's search for a mate. It would be highly inefficient, not to mention emotionally unrewarding, to attempt to get *up close and personal* with every conceivable warm body of the opposite sex during the *due diligence* process. Intuitively, we all employ certain filters that allow us to quickly screen out undesirable traits in an effort to more efficiently find our *one and only*. We take great care in developing the criteria to be used in the filtering process. The effective use of a few carefully derived filters will greatly increase our chances of finding a handful of outstanding investment ideas from a markedly smaller universe of investment alternatives. After all, we would rather spend our time performing due diligence on businesses where the opportunity for a marriage is relatively high.

Focus On the Economic Return of the Asset

The first filter is developed with an understanding of the differences between speculation and investment. Most people have their own notion about these two very different operations. Our experience would suggest that people often use the term "investment" and "speculation" interchangeably, probably because few understand the difference, and the latter is easily practiced. Ben Graham, the founder of modern security analysis distinguished the two concepts as follows, "An investment operation is one which, upon thorough analysis promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." At this year's Berkshire Hathaway annual meeting, Warren Buffett said that investors tend to focus on the asset, while speculators tend to

focus on the price. In other words, investors attempt to profit from the growth in value of the asset or from the cash flow derived from the asset, while speculators attempt to profit by changes in price, irrespective of the growth/decline in the value of the asset. The distinction between speculation and investment is important as it relates to reducing the number of potential investments.

Consider the experience of buying your first home. Was it purchased sight-unseen? Few people would consider buying a real estate property without first thoroughly investigating the physical condition of the house (asset) and its location (environment). The same logic can be applied to buying private businesses. An inspection of the physical assets, an assessment of the economic goodwill (intellectual capital, brand equity, etc.), an analysis of the competitive environment, a review of the financial statements, and other due diligence activities are routinely performed in order to assess the overall *value* of the business. In this situation, the investor is fully aware that the return he/she will achieve is most likely dependent upon the cash flows produced by the investment relative to the cash paid to acquire it. The focus is invariably on the asset in the absence of a ready marketplace with oft-quoted prices. On the other hand, the only two variables a speculator considers are the current price and some “feeling” about where the price is going, often based on recent price history.

If we had a speculator’s mindset, it would be difficult to distinguish between the thousands of stocks from which we can choose. After all, every stock has a price, which goes up and down, more or less randomly around the value of the asset. How would we differentiate between Bethlehem Steel and McDonald’s if price was our primary consideration? Indeed, stocks would trade like commodities, independent of the

performance of the business. By focusing on the asset, and its capacity to grow and produce cash flow, we considerably narrow our universe of stocks by insisting on owning companies that produce superior economic returns.

Filter #1: Record of superior economic returns

Our first filter, therefore, is a record of superior *economic* returns. The notion of economic profit is different from an accountant’s definition of profit in that the calculation of economic profit includes as an expense the (opportunity) cost associated with the capital employed by the business. To the extent a business earns a return on its invested capital that exceeds its cost (the minimum return demanded by providers of capital) the business is said to have created economic value. We naturally gravitate to those businesses that have a proven track record of creating substantial economic value over time.

While there are various techniques and formulas for measuring the cost of capital and return on invested capital, we typically use some combination or variation of return on assets (ROA) and return on equity (ROE) when measuring economic returns. Generally speaking, a business is unlikely to penetrate our first filter unless it has a long history of producing an average ROE of 15% or more over time.

Filter #2: Understanding a business

It is relatively easy to assess the economics of a business in terms of past growth rates and current returns on invested capital, critical elements to our first filter. This information is widely available from a number of financial databases. The difficulty lies in uncovering the primary drivers that led to the superior economic results. Our second filter requires that we clearly understand the factors that have been responsible for the performance of the

business *in the past*. Such analysis focuses on, among other things, the industry growth rate, the competitive environment, barriers to entry and exit, the origin of sustainable competitive advantage, switching costs, the relative power of buyers and suppliers, the intensity of rivalry within the industry, and issues that deal with the pricing sensitivity of end customers.

For most businesses, a reasonable level of due diligence can give investors a fairly good understanding of the factors that have contributed to the business' current level of growth and profitability. The key to our ability to understand the business, however, is our capacity to assess what the business will look like sometime *in the future*. Since the past is quite knowable, the key consideration for us is *the degree to which the past is useful in predicting the future*.

Our philosophy is based on an understanding that the future is full of uncertainty, and therefore, estimation of intrinsic value is always difficult. There is a large margin for error implied in any calculation of a business' value. The degree of difficulty in calculating intrinsic value (predicting future cash flows) varies from business to business. Uncertainty grows by a substantial degree when looking at businesses that are subject to rapid change and/or participate in an industry with an unstable industry structure. Industries that maintain low barriers to entry or exhibit rapid product cycles, for example, will often see a variety of new winners and losers over time. By contrast, Campbell Soup, Coca-Cola, Tide, Gillette Sensor, Snickers, and Clorox Bleach (note we certainly do not limit ourselves to consumer products and mature product lines) are products that have been industry leaders for decades.

We have a strong preference for companies that have achieved sustainable competitive advantages (as evidenced by superior

economic returns) and operate in relatively stable and predictable industries, where the proper assessment of the past is useful in understanding the future. If no precedent exists, forecasting future events and trends becomes much more difficult and cumbersome.

An example: Coke vs. Microsoft

Coke and Microsoft are both very successful companies by any measure. Take a moment to briefly consider what factors have led to their prosperity. In the simplest of terms, Microsoft's success has been the result of 1) the early adoption of DOS as the industry standard for the personal computer industry, 2) adding applications to its operating system, 3) the continued growth and upgrade cycle of the personal computer industry, and 4) Apple's failure to license its operating system. Coca-Cola's success is largely a function of 1) 70 years of accumulated brand advertising, 2) a universally appealing product, and 3) an unparalleled distribution (bottling) system.

Obviously, both companies meet our first screen of having an enviable record of extraordinary economic returns. Moreover, the past is reasonably understandable in terms of attributing the financial success of each company to the business fundamentals and sources of competitive advantage. The crux of the second filter, however, is our ability to "peer" into the future. Does the past provide any useful guidance about the sustainability of competitive advantages and growth rates? With Microsoft, our crystal ball breaks down. If we were certain that personal computers would be the core of the next technology platform, our confidence would be much higher. Technology platforms, however, seem to change over time and history suggests that new winners and losers are created in the process. Microsoft may continue to be a great company, and Bill Gates & Co. could be

very well positioned for the future age of information and digital commerce. The point is, we don't know. What we do know is that the company will need different skills and capabilities in the future to match its past success. Microsoft's future success is far from a sure thing.

Coke, on the other hand, can stick to its knitting and keep doing what it has always done. Consumers' needs for refreshment are durable and will not go away. Advertising, marketing, and availability (expansive bottling system) will still be very important determinants of consumer choice, and there is virtually no chance that a competitor will unseat Coca-Cola as the leader in these critical success factors.

Coca-Cola passes through our second filter. There are too many questions about Microsoft that, when combined with a limited understanding of technology, make the future too unpredictable. For those who have an uncanny ability to see the future of technology, Microsoft may have some investment allure.

Filter #3: Managerial decision-making

Our final general filter (other filters are industry specific) is an assessment of management. We are primarily concerned with two attributes: the performance of the business and management's attitude toward shareholders.

Business performance

We are convinced that business performance is largely determined by the competitive characteristics of the industry in which a business competes. Indeed, much of our analysis of the factors that lead to corporate profitability is directed toward industry fundamentals and trends. As such, it is not always easy to distinguish between the performance of management and the performance of the industry when examining

the profitability of a business. Perhaps the easiest and most straightforward analysis of management performance is to compare the relative performance of various companies in the same industry. If companies A and B are in the same industry and Company A consistently gains market share and earns higher economic returns, you may be able to make judgments about management performance. On this basis, it seems fairly clear, for example, that Coca-Cola has managed its soft drink business better than Pepsi over the last several years. Likewise, Nike has been better managed than Reebok. It would be difficult to make judgments about managerial decision-making, however, by comparing the business performance of Nike with that of Pepsi. Relative performance within an industry can be a useful tool for gauging managerial performance.

Corporate governance and the allocation of capital

The issues of corporate governance and the allocation of capital, while distinct, are often similarly influenced by management's approach to a fundamental issue: Whose money is it? Is management working for shareholders or merely using shareholders' capital to feather its own nest? A quick perusal of the proxy statement forces the confession of compensation and stock option policies in addition to other apparent conflicts of interest. A company's approach to acquisitions can tell you a great deal about the orientation of management as it relates to spending other peoples' money. In most instances, the only constituency guaranteed to be better off after an acquisition is management—the CEO's compensation is normally a function of the size of the company.

From our experience, a relatively few number of businesses make it through the aforementioned filters. Those businesses

that successfully navigate the filters possess characteristics that are worthy of more detailed due diligence. In the end, we have an inventory of investment ideas from which we can pick and choose on the basis of expected returns. The small universe of businesses that make it through our screens is highly complimentary and interrelated to our views related to diversification.

Concentration

Diversification, as described by modern finance, suggests that, *ceteris paribus*, risk is reduced as the number of stocks in a portfolio increases. This belief would argue for the inclusion of a large number of stocks in a portfolio. To some extent we would agree, but diversification seems to have become an end in itself, rather than a means to an end; that of managing risk. A very simple definition of risk, then, seems to be in order. We would define risk as *the potential for something to go horribly wrong*.

Diversification reduces the likelihood that if “something goes horribly wrong” with a few of the businesses in a portfolio, the impact on the *overall* portfolio will be muted. Consider the commonly referred to analogy of spreading your eggs among many baskets. If you are on an egg-carrying journey and have a number of flimsy baskets available, it would be wise to put your eggs in many baskets in order to increase the probability of having an acceptable number of eggs at the end of the journey. Obviously, the more businesses an investor has in a portfolio, the less impact a “broken basket” will have on performance. The trade-off, which seems intuitively obvious to us, is that broad diversification practically guarantees results that mirror the market over a long period of time.

Rarely considered as an alternative to employing a legion of baskets is finding a handful of sturdy, well-crafted baskets with a proven track record of successful egg-

carrying. The smaller the number of baskets, the easier it is to monitor the condition of each basket. We think this is an excellent alternative to broad diversification as a risk management tool because we do not have to give up the potential for outsized investment returns. We can stick with our best ideas and avoid the performance diluting effects of broad diversification. A concentration strategy also acknowledges the difficulty of finding phenomenal baskets at a reasonable price in a competitive environment. Of course, you better know something about the construction of baskets before embarking on this approach!

Overconfidence Bias

In practicing an approach that embraces concentration, one must be very careful to guard against the natural human tendency toward overconfidence. A bad decision in a concentrated portfolio could severely impede the compounding of the overall portfolio. Our concentrated approach and our heavy reliance on the use of filters reflects an understanding of the limitations of the human mind. We share the belief that *intuition often leads one astray in an environment of uncertainty*, often resulting in biased and irrational decision-making. There are numerous classifications of mental shortcuts—or heuristics—that are pertinent for decision-makers, but the *tendency for people to be overconfident* is quite relevant in this context.

To make the point, please answer the following questions by writing down your best estimate of the answer. Put an upper and lower bound around your estimate such that you are 90% confident that the correct answer falls within this “confidence range.”

Estimate	Range	Overconfidence Bias Test
_____	_____	1. The weight of an Olympic gold medal (in ounces).
_____	_____	2. Gross Domestic Product for the United States in 1996.
_____	_____	3. The average number of babies born each day in the United States.
_____	_____	4. Total number of square miles that encompasses Lake Michigan.
_____	_____	5. The circumference of the earth (in miles).
_____	_____	6. The number of floors in the Sears Tower.
_____	_____	7. The average annual snowfall in Anchorage, Alaska.
_____	_____	8. The weight (in tons) of an unloaded 747 jumbo jet.
_____	_____	9. The number of American Express cards in circulation throughout the world as of December 31, 1997.
_____	_____	10. The number of McDonald's restaurants worldwide as of December 31, 1997.

Obviously, these questions were intentionally difficult and subject to a large degree of uncertainty. How many of the answers do you think actually fell within your prescribed range? If two or more answers (out of 10 questions) did not fall within your estimated range, you were subject to overconfidence. After all, the ranges were to be set so that you were 90% confident the answer would fall in your range. Here are the answers: 1) 9.0 ounces; 2) \$7,792.9 billion; 3) 10,800; 4) 67,900 sq. miles; 5) 34,036,286 miles; 6) 110 floors; 7) 68.5 inches; 8) 400 tons; 9) 42.7 million; 10) 23,132. For most people, the correct answers fall within the presumed ranges 30-70% of the time. It seems the overwhelming majority of people *fail* to fully compensate for their uncertainty in setting the ranges. Indeed, one of the key tenets of the overconfidence bias is that *the level of confidence does not fall enough to compensate for an increase in uncertainty*. This effect gets dramatically stronger as the level of uncertainty increases.

The overconfidence bias has profound implications for diversification and equity strategy. Think for a moment about the difficulty in determining the intrinsic value of a business (intrinsic value being the net present value of all future cash flows). The derivation of intrinsic value requires a forecast of the future, and the future is filled with uncertainty. Simple logic would suggest that the potential for error in the

calculation of intrinsic value is much greater for businesses that are relatively unpredictable. Since we know the overconfidence bias is endemic to the human condition (some of us are more susceptible than others!), it makes intuitive sense to *concentrate* on businesses where the level of uncertainty regarding future prospects is on the low side and our understanding of the business is on the high side. We simply have no means to *reliably* incorporate and compensate for the additional level of uncertainty present in businesses that are more complex and/or changing rapidly. As a result, our filters described above are intentionally designed to filter out uncertainty.

Wrap-up

Up to this point we have discussed the three primary, highly-interrelated, ideas that contribute to our general equity strategy: 1) the use of filters, 2) concentration, and 3) the acknowledgment of the overconfidence bias. The *filters* work to create a manageable universe of solid investment candidates, from which we *concentrate* on our best ideas. A clear understanding of the natural tendency to be overconfident is a very important part of the risk management process. We have developed an approach to equity selection that we believe provides our clients with the best odds of achieving superior returns for a given amount of risk. If long-term returns are determined by the long-term performance of the *asset*, then we

can logically expect to enjoy above-average returns by focusing on businesses that earn superior returns on capital, provided we are careful not to pay too high a price.

The final step that remains before we consider purchasing the asset in client portfolios is the derivation of the asset's expected return, which is heavily influenced

by the price we pay for the asset relative to our assessment of its value. Given this *final step* is a discussion in and of itself, we will save that discussion for another time.

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