HOW TO PICK STOCKS

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You and I are investors. We approach selecting a business for investment using the same mindset we would if we were buying the entire company. This approach is diametrically opposed to that of the speculator or gambler. These *would-be investors* rarely have an 'approach' at all, other than piling into whatever has *already* gone up a lot.

"A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price."

- Benjamin Graham -

Investors make money in the stock market. They have the wind (and history) at their back. There are countless market participants who have reached both fame and fortune by truly *investing* in stocks. On the contrary, those who choose to speculate in the stock market do not make money. At least, not for any length of time. Strangely, they choose to turn the odds against them, turning a tailwind into a head wind. As true investors, we want to be successful in the long term, not the short term.

Who is the "Warren Buffett" of day trading? Who is the "John Templeton" of speculating? And finally, who is the "Charlie Munger" or "Howard Marks" of "short-term" or "momentum" investing? I don't know of any successful investor - *who has truly stood the test of time* - who advocates speculating in the stock market. To do so is to turn a veritable sure-thing into nothing more than a crapshoot.

"Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook."

- Benjamin Graham -

The long-term investor can hardly fail. The gambler hardly ever wins. We invest. We don't gamble.

So, how does the true investor pick stocks? Over the course of my career, and by studying the behaviour of the world's most successful investors, I've developed two main criteria for choosing businesses for your portfolio:

Criteria #1: it has to be a great business, AND

Criteria #2: it has be available at a great (i.e. low) price

The key here is that both of the above criteria must be met. Many investors stop with the first criteria only. Their rationale goes something like this: *"XYZ Inc. is obviously a great business. I shop there/eat there/buy their products all the time myself, and so do most of my friends and family. Let's invest!"*

"XYZ" may indeed be easy to identify by everyone as a "great business", *meeting the first criteria*. If only investing were that simple! In order for it to be a great *investment* it must also meet the second criteria. As many novice investors have learned the hard way, even a great business can be a very bad investment if you pay too much for it!

> ***"The future value of every investment is a function of its present price. The higher the price you pay the lower your return will be."***
>
> \- Benjamin Graham -

Basing our investment decisions on the first criteria alone would be akin to saying *"When we identify a great business, we will buy it at ANY price!"* Obviously no intelligent investor would make such a statement.

Conversely, buying a business regardless of quality (…good or bad), *just because the current share price appears to be cheap enough*, typically doesn't work either. This approach *could* prove fruitful, but suffice to say, a bad business is often cheap for good reason.

This also leads to why those who choose to gamble in the market rarely succeed. By paying little-to-no attention to quality OR price – they often find themselves (unknowingly) owning a less-than sound business AND doing so at a ridiculously high price! It's no wonder no-one can name the "Warren Buffett" of speculating in the stock market!

Even a high quality portfolio consisting of great businesses purchased at attractive prices will experience extreme bouts of *temporary* market volatility. But try suffering through a prolonged recession/bear market *while owning a basket of poor quality stocks that you paid too much for!* That's a scenario where one's retirement can easily be ruined forever.

How do we define a "great" business?

Most obvious, its historical performance – over the long-term – must support the notion that it's a great business. A stock that has grown at 3% a year (including dividends), over the past 15 years can hardly be a viable candidate for a great investment.

Here are some of the other criteria I look at:

- **Is the business consistently profitable?** Does the company make money, and ideally, are profits on the upswing? (You'd be amazed as to how often the 'hottest' stock or sector doesn't even make money!? In fact, I've witnessed numerous scenarios where a hot stock – that novice investors are clamoring for – doesn't even have any sales, let alone profits!). Steadily rising profits may or may not coincide with a corresponding increase in topline sales revenue. But of course, we prefer to see those figures going up as well.

- **Is it in a stable or ideally growing industry?** A 'great' business (…well-run company that makes money, *today*) in a dying industry can hardly be a contender for a great investment.
- **Is the business well managed?** A good business in a growing industry can still be a bad investment under poor management. Much can be gleaned about the quality (…or lack thereof) of the management team by analyzing the balance sheet. Is the company carrying too much debt? Have they overpaid for past acquisitions? Are they constantly having to raise capital, diluting the stock and/or adding to the debt load?
- **Perhaps most important, does the company enjoy a *sustainable* competitive advantage?** This is what Buffett refers to as a 'moat' or barrier to entry. A well-managed business with increasing sales, earnings, and a healthy balance sheet – *but without some sort of barrier to entry* – will simply invite competition. And as competition increases, so does pricing pressure and costs – hindering future profits. What we thought was a great business may be a 'house of cards' if it doesn't enjoy the benefit of having a moat around it. A truly great business enjoys some sort of a *sustainable* competitive advantage.

> ***"If you have a castle in capitalism, people are going to try to capture it. You need two things – a moat around the castle, and you need a knight in the castle who is trying to widen the moat."***

- Warren Buffett -

These are just a handful of the characteristics of a great business. Of course, there are many more. But without digging too much deeper, if I can answer 'yes' to all of the above, we can be confident that we're looking at a great business and a good candidate for investment.

What is a great price?

Once we've found what we believe to be a great business for potential investment, how do we determine what represents a great price?

Again, this is a key part of our approach, and it differentiates how you and I invest from most other market participants (i.e. the novice investors, speculators, and gamblers – who typically have no regard for (or idea of) what represents good value?).

Next time you're "advised" by a friend, colleague, or family member to invest in anything – ask them at what price they'd sell that same investment? I'd be willing to bet that what you'll get next is a blank stare (…and if they say something like '*once it doubles*', I'd suggest you don't just walk away; RUN!). In essence what they're saying is that the price doesn't matter, you should just buy it. Anyone who thinks that sort of approach constitutes actual investing in any way, shape, or form clearly should not be making any of their own investment decisions, let alone giving advice!

> ***"Serious investing consists of buying things because the price is attractive relative to intrinsic value. Speculation, on the other hand, occurs when people buy something without any consideration of its underlying value or the appropriateness of its price."***

- Howard Marks -

Here are some of the factors we use to determine a great price:

- **Are the shares currently trading at an attractive price in relation to the profitability of the business?** *Our motto: no profits = no price is low enough* (…again, we're investors – not gamblers; those who are willing to bet their savings on the notion that a business that has never made any money in the past, may *one day* miraculously become profitable!). A business that has $10million of annual profits, with a current share price that values the company at around $300million (…30X one year's earnings), is clearly NOT a candidate for an attractively priced investment. In this scenario, the "investor" is essentially saying they're willing to wait 30 years to get their principal back. Clearly no reasonably intelligent investor would sign up for such a proposition (…and yet, with the extremely popular S&P500 index currently trading at almost 33 times earnings, novice investors seem more than willing to do just that. My hunch is that they have no idea. In this case, the S&P500 index may be a perfect example of a great investment (based on its stellar long term track record), but one that is clearly NOT trading at a great price. At least, not at this particular point in time – for those who are paying attention).
- **Are the shares currently trading at an attractive price in relation to the underlying assets held by the business (i.e. the shareholders)?** Some semblance of the current price in relation to what you'd end up with if the entire company was 'wound up' is obviously important to consider. After all, businesses fail – or better yet, are acquired by larger businesses. Knowing what we might receive in either scenario is just being prudent; another basic hallmark of 'intelligent' investing. (And here again, I'd venture to say that far too many would-be investors don't have a clue of the value of the underlying assets. If you are in the market for a new home, you may indeed find your absolute dream home; but you wouldn't be willing to pay ANY price for it. For example, no reasonably intelligent buyer would pay over $4million for a $1million house. However, using the current price of the S&P500 index again, many investors are doing just that – with the index trading at 4.6X the total book value of the businesses that make up the index. In this scenario, they're paying more than $4 for each $1 of underlying assets?).

"Consciously paying more for a stock than its calculated value – in the hope that it can soon be sold for a still higher price – should be labeled speculation."

- Warren Buffett -

In summation, we pick stocks using the same approach we would take if we were buying the entire company. We only buy quality AND we refuse to overpay.

As is customary in these missives, it seems appropriate to leave the final word on this with the author of "*The Intelligent Investor*"…

"By refusing to pay too much for an investment, you minimize the chances that your wealth will ever disappear or suddenly be destroyed."

- Benjamin Graham -

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