

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 50."

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.

My firm has benefited from tracking new-lows lists. For example, I missed an opportunity to invest in Apollo Group, the for-profit higher-education business known as the University of Phoenix, in 2001, when the stock price was near \$20 per share. By the end of 2001, the stock price rose to more than \$30 per share, and by the middle of 2004, it rose to \$100 per share.

Although I missed the opportunity to invest in 2001, I continued to research Apollo Group by attending industry conferences, listening to conference calls, and keeping up with SEC filings. Five years later, I was able to act decisively when the stock price dropped from \$60 per share at the beginning of 2006 to \$35 per share on November 14, 2006 due to an options backdating scandal. I was able to discover the opportunity because I was continually monitoring the new-lows lists and saw that Apollo Group's stock price had dropped. Also, because I had consistently followed the business over a long period, I knew investors were overreacting to the scandal. By the beginning of January, the stock was trading for more than \$40 per share and by July it appreciated to \$60 per share. Had I not prepared in advance and monitored new-lows lists, I would have missed the small window of opportunity to make this investment.

Reading Newsletters, Alert Services, Online Recommendations, and Media Recommendations

There are many publications that tout stocks. It is better to stick to those services that are fact-based, such as *Bankruptcy Week* or *Distressed Company Alert*, rather than those services that are more interested in selling subscriptions by marketing high rates of returns to their subscribers. Fact-based publications are those where no opinion is attached and instead corporate events are chronicled. Be aware of self-serving recommendations and less-than-transparent presentations of results. Some newsletters will exclude certain stocks they have recommended in the past when presenting their overall rates of returns, and instead present only those that have done well.

Using Value Line

Value Line is a great source for you to build knowledge on certain businesses or industries. It presents much critical information on a single page. A typical stock report shows 10 years of financial information, including sales, operating margin, depreciation, net profit

margin, income tax rate, working capital, long-term debt, and shareholder equity. It also shows historical returns, such as return on total capital, return on shareholder equity, and return on common equity. There is also a quick write-up of significant developments over the last quarter as well as a historical stock chart.

Each week, a new issue comes out highlighting a group of stocks within an industry, such as auto and truck, precision instruments, electric utilities, or medical supplies. I read each issue from beginning to end looking for new ideas. This also builds my understanding of new businesses and industries. I borrowed this idea from Charlie Munger, Vice Chairman of Berkshire Hathaway, who mentioned at an annual meeting that he leafs through these reports regularly to learn more about different types of businesses as well as to find opportunities. The main limitation of this source is that its publications cover only 3,500 stocks, and not all 9,000 publicly traded stocks in the United States.

Following Other Investment Managers

Many investors (professionals included) generate ideas by closely tracking the holdings of well-known investment managers with above-average track records. There always seems to be a hot group of investors that others follow, although most aren't followed for long. These are usually investors who have had recent success, so the media constantly reports their new holdings.

The problem with following others is that most of these great records were generated by *past* investments, and investors wrongly conclude that *existing and future* investments will have similar results. Many of these investors fall in and out of favor (for example, when investors began to question the investment wisdom of Warren Buffett when he was telling investors to avoid high-priced Internet stocks in 1999), and it is typically when they are out of favor that you should be following their holdings. Investors who manage the largest amounts (i.e., more than \$100 million) have to disclose their investments each quarter in an SEC 13-F filing, so following them is straightforward (albeit slightly delayed).

Early in my career, I occasionally sourced investment ideas from these managers. When the filings came out, I would be excited to discover that the investment managers I admired had made some new investments or significantly increased their position in a stock.

If it was an investment idea I understood, this excitement translated into higher conviction, sometimes causing me to cut corners on my own research.

There are several disadvantages to following other investment managers:

- Most great investment track records come from a limited number of investments. For every 10 investments a successful investment manager makes, only one will appreciate substantially, contributing outside returns to the investment record, while the others will either mildly perform or underperform.
- You typically will not know the reason why a certain investment manager is buying or selling a stock. Perhaps the investment manager is suffering from investment redemptions and he or she needs to sell stocks.
- No matter how good they are, all investment managers will make mistakes, and you may be following them into such a mistake.
- Investment managers change their strategies. Recognize that the strategies the investment manager followed in the past to generate the superior investment record is not necessarily the strategy the investment manager is following *today*.

Therefore, in the end, be careful about following the ideas of other investors.

Casually Reading the Business Press

You can generate ideas from the business press by regularly reading publications such as *Barron's*, the *Wall Street Journal*, the *Financial Times*, *Forbes*, and *Fortune*. Consider subscribing to trade journals as well, such as *American Banker* (if you are interested in financial-services stocks) or *Las Vegas Review-Journal* (if you are interested in casino stocks).

As you read the articles, you'll not only ground yourself in industry basics, but you'll uncover descriptions of management teams you'd like to invest with. The best investment ideas usually come from those businesses that are in distress. Focus on those articles that are not success stories but those about distress, to give you better odds of finding a well-priced investment.

For example, First Manhattan senior managing director Todd Green remembers how he first became interested in the diversified industrial conglomerate Tyler Corporation. Green read an article in *Forbes* (in 1990) where CEO Joseph McKinney said he would not consider doing a leveraged buyout (LBO) because this would put him on the opposite side of the table from shareholders. This was during the days of a serious amount of LBO activity, and the comment signaled to Green that the CEO had the right attitude regarding the alignment of shareholders and management interests. Green purchased the stock on April 26, 1991 at \$3.07 per share and sold it on June 8, 1998 at \$9.99 per share, a compound rate of return of more than 18 percent.⁵

Buying Shares to Track a Business

You can buy a few shares in a stock that meets your criteria to force yourself to follow the business. By purchasing a very small piece of a business, you've guaranteed that you will not forget the business, and that you'll have consistent reminders about that business. Paul Sonkin of the Hummingbird Value Fund calls this his *grab bag*. In his personal account, Sonkin has purchased one share of more than 300 companies. In the mail each day, he usually receives something from some of the companies. He has followed some of the companies for many years, and he uses this method as a way of filling his in-box with companies that he has already screened as being interesting.

For example, Sonkin was able to invest in Control Chief Holdings, a manufacturer and marketer of wireless remote control equipment primarily used in the railway industry, which was trading for \$250 per share. Sonkin had followed the business over some time and learned that the business had more than \$147 per share in net cash and estimated that it had \$25 per share in earnings power. Therefore, at an enterprise value of \$103 per share, Sonkin bought the stock at four times normalized net income, an extremely low price.⁶

Don't Ignore Your Existing Investment Portfolio

Admittedly, it is more exciting to discover opportunities outside of your portfolio, but it's not necessarily more beneficial. Many investors forget to look at their existing portfolio for ideas. Often, your

best opportunities are right in front of you. If a stock you hold drops in price, this may represent the best investment opportunity for you, especially compared to a stock you know less well.

For example, when the S&P 500 dropped 36 percent in 2008, there was an abundance of opportunities. Instead of attempting to analyze many of the new opportunities being offered, my firm decided to analyze our own portfolio holdings that were trading at significantly lower prices than they had just weeks or months before. At one point, our core holding Whole Foods Market traded at close to four times enterprise value to free cash flow, which means we could have bought the whole business (including debt net of cash) and paid for it in four years out of existing depressed free cash flow. We ended up buying more of our existing holdings, such as Whole Foods Market, which helped us generate a net return that was far superior to the S&P 500. Had we analyzed new potential holdings, we probably would not have increased our existing holdings and not generated an excess return.

Research Upcoming IPOs

You can regularly research IPOs, spin-offs, and stocks of companies that are exiting bankruptcy, all of which are new businesses to the stock market. You can subscribe to various services that will alert you to these new entrants, such as Gemfinder's *Spinoff & Reorganization Report*. Once alerted, you should read the prospectus that accompanies an IPO, spin-off, or stock exiting bankruptcy, because these are especially rich in information and are much more useful than a standard 10-K filing. The biggest advantage of tracking these businesses is that there is not a public price to influence you. You can calculate a reasonable valuation range for the business in advance, and then compare your value to the business's trading price.

For example, I analyzed pediatric nutrition business Mead Johnson Nutrition before it was spun-off from parent Bristol-Myers Squibb. Because, there was not a public price to influence me, I determined that the stock was worth \$40 per share and that I should buy it at any price below \$30 per share. When the price of the spin-off was set at \$27 per share in February 2009, I purchased the stock, which quickly increased to \$43.70 at the end of 2009. Had I not prepared in advance, I would have missed this opportunity.

How to Filter Your Investment Ideas

So far in this chapter, I have shown a few of the ways you can gather investment ideas. The rest of this chapter demonstrates ways to filter these results and begin evaluating investment candidates that you may want to include in your set of potential investments.

Criteria Is a Filter

When filtering through the many investment opportunities the stock market is offering at any given time, it is important for you to establish criteria of the types of businesses and management teams you are searching for. These criteria serve as a filter, so you don't have to review thousands of investment opportunities and therefore can reject investment ideas quickly. If you have ever purchased a home, when you first started looking, you were probably overwhelmed by the number of houses that were available. At some point, you probably began to establish criteria for the types of houses and areas you were interested in, and this helped you narrow the list of houses that were potential candidates for purchase. The investment criteria you develop will work in the same way.

Your criteria can be as simple as looking for a simplified business with a large market opportunity, managed by a great management team, and trading at a low price. You can also set criteria of what you do *not* want to invest in. For example, you may want to avoid businesses that have a high dependency on commodity resources, such as exploration and production (E&P) businesses, because oil prices are difficult to forecast. By articulating and following strict criteria, you can put the odds of making a successful investment in your favor.

Table 1.1 is something you might want to consider using in order to make comparisons among different types of businesses. You can list what your preferences are for a business, such as these:

- A recurring revenue stream
- A business with high organic growth prospects (i.e., growth that is *not* accomplished by acquiring or merging with other businesses)
- Management that has a long tenure at the business
- A competitive moat

Table 1.1 Sample Criteria Checklist

Name of Company	Recurring Revenue	Long Runway	Proven Management	Potential Holdings					Diversified Customer Base	Strong Balance Sheet	Total
				Franchise	Strong Financials	High ROIC	Limited Competition	Low Capital Expenditures			
Discount, Variety Store	√	√	√	√	√	√	√	√	√	9	
Personal Financial Services	√	√	—	√	√	√	√	√	√	9	
Education & Training Services	X	—	—	√	√	√	√	√	√	7	
Online Travel	—	—	X	√	√	√	√	√	√	7	
Asset Management	√	√	√	√	√	√	√	√	√	10	
Sporting Goods Store	√	√	√	√	—	—	√	—	—	6	

KEY: √ = Possesses, X = Does Not Possess, — = Don't Know

- Strong existing or potential financial characteristics, such as high free-cash flow
- High existing or potential returns on invested capital
- Limited competition
- Low capital-expenditure requirements
- A diversified customer base
- A strong balance sheet

A check mark indicates that the business possesses a certain attribute, such as a high return on invested capital, whereas the X mark indicates that it does not. You can make a simple tally of how many attributes the business exhibits. This serves as a scoring system and helps you compare different businesses from different industries.

Evaluating the business in each of these 10 areas will help you understand the tradeoffs you are making when investing in a particular business. Perhaps you found an investment with a strong competitive advantage, yet the business has limited future growth prospects: Using the criteria in Table 1.1 clarifies the advantages and disadvantages of such a business as well as its potential dangers. The more closely a business meets your stringent criteria, the less risk you are taking. For example, it is easier to monitor a business with limited competition rather than one that has a lot of competition. If a business meets only four or five of your criteria, you can usually pass on the business, as most investment mistakes are made when you stretch your criteria.

Once a business meets your criteria, it is important to track it. You may want to create a spreadsheet where you list the businesses that meet your criteria, similar to the example in Table 1.2. It is essentially a formal watch list of businesses and can range from a few ideas to hundreds of ideas.

Once you add an investment to your list, you should begin learning about the business and management team, and track the valuation of the business using financial metrics such as free cash flow (FCF) yield or total enterprise value (TEV) to earnings before interest and taxes (EBIT) to alert you if a business drops in value. Because of the GAAP issues mentioned earlier, you may want to avoid using valuation metrics such as price-to-earnings ratios. Also, you don't need to update these spreadsheets yourself; instead, there are various services you can use to update the numbers on a daily basis, such as Bloomberg or Standard & Poor's Capital IQ.

Table 1.2 Inventory of Ideas

Name	Ticker	TEV/EBIT	TEV/EBITDA	TEV/Normalized Earnings	Pre-Tax Earnings Yield	Debt to EBITDA	EBIT/Interest Exp	FCF Yield EV	FCF Yield Market	Dividend Yield (%) EV	Last market Price	Free Cash-Flow Estimate	Target Price	Stock Price vs. Target
Western Union Co.	WU	10.1x	8.9x	18	9.9%	2.2x	8x	6.77%	7.47%	1.30%	\$18.73	\$1.40	\$20.51	91%
Whole Foods Market, Inc.	WFM	19.1x	11.9x	32	5.2%	0.7x	14x	4.14%	4.14%	0.00%	\$49.71	\$2.06	\$34.76	143%
Dell Inc.	DELL	6.0x	4.6x	10	16.8%	1.4x	17x	12.92%	9.69%	0.00%	\$13.41	\$1.30	\$20.09	67%
Penn National Gaming	PENN	13.5x	8.3x	37	7.6%	3.9x	2.5x	6.56%	10.94%	0.00%	\$34.72	\$3.80	\$25.00	139%
Morningstar Inc.	MORN	19.9x	15.0x	32	5.0%	0.0x	0.0x	4.62%	4.03%	0.40%	\$52.64	\$2.12	\$30.00	175%
Moody's Corp.	MCO	9.0x	8.3x	16	11.0%	1.5x	15x	5.13%	6.58%	1.60%	\$27.35	\$1.80	\$20.00	137%
Strayer Education	STRA	9.4x	8.7x	15	10.7%	0.0x	0.0x	4.85%	4.42%	2.70%	\$158.26	\$7.00	\$160.00	99%

Source: Capital IQ, December 14, 2010

KEY: TEV = Total Enterprise Value; EBITDA = Earnings Before Interest, Taxes, Depreciation, and Amortization; FCF = Free Cash Flow

Valuation Is a Filter

The one thing you can't fix after making an investment is the price you pay, so it is critical to remain disciplined on price. Your future rate of return will be determined by the price you pay for the business. This is why you should only consider those investments that are trading at a low price. The following case study gives you an example of how investment manager Brad Leonard generated high returns for his investors by paying low prices.

Brad Leonard founded BML Capital Management, LLC in 2004. He has compounded capital at a rate of 26.94 percent, net after fees from 2004 to 2010, compared to 3.87 percent, net for the S&P 500. He credits this record to being disciplined about paying low prices for stocks. He typically pays three times enterprise value (EV) to EBITDA for a stock, and he prefers to buy businesses that do not need a lot of capital expenditures to maintain their businesses and those that have little to no debt. In 2009, when the stock market was declining, Leonard was buying stocks at one to two times EBITDA. Leonard says, "When you are paying one or two times EV EBITDA, not much needs to go right. If the business survives, you win. As long as the business does not end, you don't need to make a lot of great assumptions in your analysis. If instead I were paying a 5 percent earnings yield (earnings divided by market capitalization) on depressed earnings, it would not really be that cheap."

For example, Leonard first began buying Kirkland's, a home décor retailer, at \$1.70 per share in the fall of 2007. Shortly thereafter, the stock price declined to \$0.70 per share (when the stock market declined by more than 36 percent in 2008). As Leonard was buying Kirkland's, the fundamentals of the business continued to improve. After reporting negative comparable store sales in the fourth quarter of 2007, Kirkland's same-store sales turned positive in the first two quarters of 2008. Cash flows, comparable store sales, and margins all continued to improve, yet the stock price continued to decline. Leonard stepped on the gas even more in his purchases. He said, "Every quarter, the results of Kirkland's would improve, and it seemed that no one cared. At this time, I thought it was likely the company would post around \$20 million in EBITDA, so in essence, I was buying the stock around 1 to 2 times EV to EBITDA." The stock eventually recovered to around \$2 per share by 2008, and by 2009, it was trading at more than \$20 per share. Leonard's disciplined buying was well rewarded.⁷

Using a Spreadsheet to Track Potential and Existing Holdings

There are many advantages to using a spreadsheet to track your potential and existing holdings. First, the discipline of placing newly developed investment ideas in a spreadsheet lets the novelty of the new idea wear off, and it helps you counter your natural desire to act on impulse and buy a stock. You will not feel as if you are about to miss the opportunity of a lifetime because you have many choices to invest in. Most of us look for stocks that are cheap and then study the business and assess management. By the time you are up to speed on the business and ready to buy, the opportunity is gone. After this happens a few times, you will begin to feel a sense of urgency whenever you spot a new investment idea. You might be tempted to short-cut your research process so that you will not miss another opportunity.

Having such a spreadsheet, however, allows you to optimize the use of your time by allowing you to concentrate on those opportunities with the greatest upside potential and lowest downside risk. Instead of *scrambling* to analyze the many investment opportunities being offered to you by the stock market, you can *carefully choose* from the best opportunities in your spreadsheet.

The greatest advantage to maintaining an inventory of existing and potential investments is the ability to make comparisons. If you are comparing your existing holdings with hundreds of potential investment opportunities rather than a limited set, you increase the probability of making good investments and avoiding bad ones. The more comparisons you can make in your spreadsheet, the higher the probability of uncovering an investment idea. In addition, those comparisons will increase your awareness of areas of the stock market and individual stocks that are out of favor. You can gradually build your spreadsheet over time or proactively build it—two approaches that I'll discuss in the final sections of this chapter.

Gradually Building a Spreadsheet of Potential Investments

When you do not have investment opportunities that you are ready to act on, you can use your time to prepare for future opportunities. When you identify a unique business or superior management team, add the business to your inventory of ideas or watch list, regardless of its current valuation. This is the secret sauce to investing intelligently, because it allows you to *act decisively* when a good

opportunity is in front of you, and it prevents you from *acting imprudently* when you first have the idea or insight. In essence, you are letting time work in your favor.

Be Proactive

One of the biggest advantages of investing in public markets is that you can identify every business in your investable universe. You have the ability to review more than 9,000 publicly traded businesses one by one. You can look for those businesses that meet your criteria. Exclude those businesses that you do not believe you can accurately value because this will help you get through the list at a quicker pace. This will help you narrow down the number of businesses you consider investing in from 9,000 to a more manageable several hundred.

Once you have some ideas of the companies you're considering investing in, there are a couple of preliminary questions you should ask yourself before getting into the nitty-gritty of researching those businesses. Turn to Chapter 2 to discover the first several questions of *The Investment Checklist*.

Key Points to Keep in Mind

- You will not have many outstanding investments in your lifetime.
- Investment opportunities are created when capital is scarce. Capital becomes scarce when one or more of the following events occurs:
 - An entire market declines
 - There is forced selling from a stock being thrown out of an index or if it is spun off
 - There is some type of uncertainty about a business that causes investors to sell their stock
- If you use stock screens to identify investment ideas, understand that you may miss many investment opportunities because most screens are based on GAAP accounting numbers which may under- or overstate the earnings of a business.
- Be careful when following investment managers in their investment ideas.
- Use specific criteria to filter out the investment ideas you don't like.
- Create an inventory of ideas to track potential investments that meet your criteria on a continual basis in order to prepare for future opportunities.