CHAPTER 1

Introducing Our Investment Process

How should decisions be made on buying, selling, and holding stocks? In a perfect market, those decisions are made on the basis of fundamentals. In this case, we mean the specific characteristics investors feel are important when selecting a company for their equity portfolio.

Of course, the fundamental principle of the market is that prices at the moment are based on expectations of a company's performance in the future. The price today reflects how investors collectively believe the company will perform days, weeks, months, or years from now.

Time horizons come into play. Long-term investors are using their views to forecast a company's results perhaps five years from now, or three, or two, or next year. Investors with short horizons who are seeking to capture quicker profits likely are projecting results in months. Thus, prices are based on expectations and predictions and the future. No one can predict the future accurately. Some investors who do it better than others make a lot of money, for a while. Hopefully, their talent never leaves them.

What do we mean by a company's fundamentals? In sum, they focus on the ability of management to generate certain levels of revenues and cash, and to run their operations effectively, resulting in profits and excess cash that are reinvested to achieve more revenues and cash, which drive the stock price higher.

An accurate analysis of a company's historical fundamentals is the staging point of determining if the stock is fairly (close to the price), under-, or overvalued. An investor also has to develop a view of a company's performance to gauge future results. An investor who can more accurately assess these drivers will be more successful. Undervalued stocks are purchased for the investor's portfolio, while overpriced stocks are sold. Fairly priced stocks are kept when the investor is confident the company can continue to create new value. They are sold when the investor is convinced the fundamentals are about to lead the company's performance downward. This investment method has been called a "buy-low and sell-high approach." It is a longer term investment approach. But how does an investor know when a stock

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is under- or overvalued? The model we discuss in this book is well suited to accomplishing an accurate analysis of the fundamentals of a company to determine its intrinsic value.

Of course, the market eventually has to recognize the intrinsic value of a company, buying shares to push up the price or selling shares to drive the price down closer to fair value.

It is our contention that prices are doing just that—moving toward fair value, based on good analysis of the fundamentals of each company. This process encounters many bumps in the road caused by human behavior as investors respond to a plethora of factors or pursue perceived opportunity or react in fear. Many times, these responses and actions and reactions are over the top.

Indeed, it may be harder for you to believe that prices of stocks move toward fair value today, given market behavior in the past few years.

The issue comes down to whether investors want to hold companies in their portfolios based on the best fundamental analysis of their values. Or do they prefer to "play the market," basing their decisions and actions on investor behavior and momentum?

Objective observers of behavior over recent years are inclined to conclude that the market is being driven primarily by sentiment and momentum rather than by good analyses of the fundamentals of company after company.

In support of this unfortunate trend, there has been an upswing of models aimed at capturing high returns by observing market behavior accurately. These models often are built on computer-generated quantitative data analysis of recent investor behavior with the expectation that it will continue or change. Or they are built on determining the prime factors driving investor actions and statistically regressing these factors, such as earnings acceleration or earnings surprises or relative price strengths. The problem is that these models essentially analyze what recently has happened in the market, not what is coming next. Their unstated assumption is that trends always continue. But trends continue for a while until they don't, and when they don't, you can lose a lot of money.

All this has led to more trading of shares and dramatic increases in trading volume as investors try to catch gains or cut losses. This cumulative action is causing a market that is more short term in its horizon. Add to it what appears to be a growing number of investors building models designed to capture gains more quickly. In fact, our sense is that a significant majority of research dollars is going into short-term tactical trading instead of long-term, cash-based, fundamental intrinsic valuation. We even suggest that this research emphasis is making the market less efficient, not more.

Certainly, greed is at work here; fear has been brought back recently with the severe market downturns. But investors and the media can make a

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good case for blaming the market decline on big macro factors, such as the subprime mortgage debacle followed by a recession, leaving the justifications for using these short-term models—earnings models, momentum models, multifactor regression models—intact.

Where does this leave investors who want to analyze the fundamentals and make decisions based on the performance and prospects of each individual company?

It certainly would appear that more of the investment community has been moving away from fundamental analysis. We have to ask the question: Are they doing this because they believe the approach is no longer viable or because market realities leave them no other choice?[1]

Surely, some investors who were previously focused on the fundamentals have lost some confidence or courage and have switched horses in the face of what can appear to be a stampede. But we think the percentage remains small and investors with longer-term horizons and methodologies based on good analysis of the fundamentals of businesses still constitute the foundation of equity investing.

We hope that business fundamentals always will constitute the foundation of stock investing because it constitutes basic common sense and unquestionably proven best practice.

Stocks should be bought and sold based on the fundamentals of the business, analyzed and understood to the best ability of investors.

And our job now is to convince you that this proven methodology has gotten even better and we are closer than ever to accurately calculating the intrinsic value of every company with information available to the investing public. Also, because fundamental investing may be less popular now, it

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[1]On the one hand, academics are fond of assuming that all investors are "homogeneous." This means that all investors use the same tools, look at the same information, and employ identical models. Reviewing a sampling of investment advisor ads reveals how unrealistic this homogeneous assumption is. Each ad tries to portray its unique offering.

On the other hand, behavioral finance academics note how wide the ranges of prices are within any time period—day, week, month, or year. These ranges of bounded rationality simply are too wide to be caused by changes in the fundamentals (Robert Shiller "Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends," *American Economic Review*, January 1981, pp. 421-436; Vernon Smith, "Experimental Methods in the Political Economy of Exchange," *Science*, Vol. 235, October 10, 1986, pp. 167–173; and "Stock Market Experiment Suggests Inevitability Of Booms and Busts," *Wall Street Journal*, November 17, 1987). Consequently, we suggest that the market overreacts and underreacts when new information arrives. Only by calculating an intrinsic valuation as the "anchor" can we estimate where the price resides within its gyrations of market sentiment.

will be more profitable for investors who continue to follow the process. Contrarian investing always is more profitable.

We want you to become a member of the small band of courageous, economic, cash-driven investors—called “Cash-Loving Contrarians.” Together, we can grow into a powerful force driving the market based on solid fundamental analysis.

KEY TAKEAWAYS

1. Investors should buy, sell, and short stocks based on the intrinsic value derived from the economic fundamentals of the underlying firm’s business.
2. Investors should concentrate first and foremost on the long-term cash fundamentals of the business to produce intrinsic valuation levels, not short-term price momentum or multifactor approaches created from price change models.

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