

# Hedge Fund Analyst Checklist

One of the turning points in my early career was taking a security analysis class taught by Tiger Cub John Griffin at UVA. There are some old posts in the archives on the topic, but needless to say it was a great experience for a bio-engineer and is part of the reason I moved away from the lab bench and towards quant investing (whether that was a net plus or minus to society TBD).

Anyways, I was cleaning out some old files and came across these notes from the class and thought I would repost them as they are a wonderful guide for a young analyst on how to think about investing in stocks. While the list is a bit dated (from university in 2000) the message is still valid. Other investors that promote using checklists include Buffett, Munger, and Pabrai (here is [Pabrai's PPT to Columbia](#) on the topic).

## INVESTMENT FRAMEWORK

### Industry Study

- Is this a good business? What are the key success factors to superior performance in this industry? (Value Added Research “VAR”)
- Define the market opportunity. How do competitive products address this opportunity?
- What are the barriers to entry (“moats”)? (VAR!)
- What is the relative power of: (VAR)
  - Customers
  - Suppliers
  - Competitors
  - Regulators
- Who controls industry pricing? Does the company/sector have any pricing power?
- How (and how much) can a good company differentiate itself from a bad one in this industry?
- Do you understand this business? Test yourself and describe it to a ten year old. DO THIS!

### Business Model (VAR)

- What is the selling model: razor/blades? services? one-off contracts?
- What are the economics of the base business unit? How does it stack up against competitors?
- Why is the company good (or bad) at what they do? Can they sustain it?
- Is this company growing by acquisition? How sustainable is that?
- Be able to easily describe the entire sales process – from order to fulfillment.

### Management (VAR)

- What is their background, and what do their former colleagues, investors, classmates, say about them? Have they been successful in the past? (Very important)
- How are they compensated? Are their interests aligned with shareholders?

- Have they been good at allocating capital?
- Are they buying or selling stock? How much as a percentage of their holdings, and why?

### Company/Cultural Issues (VAR)

- Is this a great company? Is it built to last? What could change this assessment?
- Can you imagine holding stock in this company for twenty years?
- If you had access to unlimited capital, how would you feel about your chances of successfully competing against this company?
- Compare to a weak competitor in the same industry. What is the difference and why?

**Financial Measures** First Step: Check against all the accounting shenanigans in Howard Schilit's book ([Financial Shenanigans: How to Detect Accounting Gimmicks & Fraud in Financial Reports, Third Edition](#)) *Balance Sheet*

- What is the company's capital structure, and how does it compare to its peers?
- What are the trends in inventory turns, days payable/receivable, and working capital?
- What are its coverage ratios on interest payments?

### Cash Flow

- What are the company's capital requirements and cash flow characteristics?
- How is the company choosing to invest its capital? CapEx? Buybacks? Acquisitions?
- Does the company need to access the capital markets? How soon/often?

### Earnings/Profitability

- Regarding the company's sales model, how visible are earnings quarter-to-quarter, and year-to-year?
- Is this a fixed or variable cost business? How much cost leverage?
- Do earnings grow as a function of unit sales growth, price increases, or margin improvement? How sustainable is this growth?

### Valuation

- Looking *forward*, what is the company's valuation in terms of:
  - Market Value/Earnings
  - Enterprise Value/EBITDA
  - Free Cash Flow Yield (After-Tax Free Cash Flow/Market Value)
  - Market Value/Sales
- What is the company's growth rates in terms of earnings, EBITDA, and FCF?
- What are consensus earnings estimates, versus your own expectations?
- What are the key leverage points in our own and the street's earnings models? What has to go right, and where is the most chance for surprise?
- Are their accounting policies conservative and in line with their peers?

### Risks

- What are the big unknowns? How much can the company control/influence these risks?
- What could cause this investment to be a total disaster? How bad could it be?

### **Other (Timeline/timing issues) DO A TIMELINE!**

- What are the catalysts (triggers) for the company's proper valuation to be realized?
- What good news, and what bad news, will affect the company in the coming year?
- Who owns the stock? Momentum funds? Big mutuals? Hedge funds?
- How difficult is it to build a significant position (float, volume)?
- Draw a time line of expected events and dates. What might go wrong and when?

### **Investment Framework: Short Questions**

#### 1. Is this a bad business?

- Who has the power – customers, suppliers, competitors?
- What are the barriers to entry?
- What kind of reinvestment of capital is needed to grow?
- How is the business changing?
- What is the historic and current rate of success in this business?
- What are the major risks to the business plan?

#### 2. What is the major misperception?

- Why does it exist?
- Who is responsible for it?
- What stakes do the various parties have in keeping the stock price high?
- How popular is the industry? rising tides lift all boats – for awhile.

#### 3. Assess management

- Industry reputation?
- Past history of success or failure.
- Straightforward or cunning?
- Check out insider ownership and selling.

#### 4. Ratios:

- EBIT/EV as a percentage.
- (EBITDA-CAPEX)/EV as a percentage.
- Growth of inventories to cost of goods sold – are inventories rising faster?
- Growth of AR to sales and AP to sales.
- Any accounting changes – smaller reserve for bad debt, revenue recognition, etc.
- Cash flow/Int. expense.
- **Review Howard Schilit's red flags**

5. Sentiment: Are more people bullish or bearish on the stock?

- Do full media search for articles. Make list of analyst recommendations.
- Short Interest? SIR (remember, the stock that is already short is potential buying power) Be careful if there is universal bearishness.

6. Timing

- What is the expected trigger on the misperception? **Do a time line.**
- Who owns the stock – long term or short term, momentum investors?
- Has the souffle already risen once?
- Can the rising stock price be self-fulfilling for awhile (financing opportunities, etc)?
- Where does the company stand in terms of the fantasy, transition, reality paradigm?

7. Add when the story starts to unfold — regardless of stock price.

- Watch for earnings warnings, excuses, etc. Where there's smock, there is often fire.
- Is the company or wall street analyst group in denial of the problem?
- Watch the ratios, insider selling etc.
- Even if the stock down significantly from its high, if answering all these questions convinces you that it is still a short, do not cover and consider adding. See below
- **Does waiting for the new financials feel like waiting for Christmas? IF "YES" —> ADD.**