Reflections on the Ten Attributes of Great Investors

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Welcome VIP

Today's value content actually comes from another VIP.

Rich passed along a PDF that was just too good for me to read on my own.

It's a 21 page letter authored by Michael J. Mauboussin, Dan Callahan and Darius Majd from Credit Suisse. Easy to read and not as long as you think.

Click to download: Thirty Years: Reflections on the Ten Attributes of Great Investors

A couple of weeks ago, I was in Washington DC visiting museums and learning more about American History, arts and other good stuff.
Seeing as how I became a US citizen only 1.5 years ago, it's been fascinating to learn how the US became the super power it is today.

USA as a country is very young compared to many nations that existed B.C, yet the US is the biggest economy and leader in the world.

I strongly believe that a lot of the content in this PDF also applies to how US became what it is today. And by applying or training yourself to acquire the same 10 traits, you'll also be an "investing superpower".

Quick Summary

- The ability of accounting numbers to represent economic value is severely limited.
- Competitive strategy analysis and valuation should be joined at the hip. The litmus test of a successful strategy is that it creates value, and you can't properly value a company without a thoughtful assessment of its competitive position.
- Stock prices reflect a set of expectations of future financial performance.
- Company stock doesn't generate excess returns solely by the company creating value. The company's results have to exceed the expectations embedded in the stock market. This is why it's so important to run reverse valuations to calculation market expectations.

#1: Be numerate and understanding accounting

- Accounting is main language of business
- Free cash flow is what is left over after investments have been subtracted from cash earnings. It is also the sum that a company can return to its claimholders in the form of interest payments, dividends, and share buybacks, without jeopardizing a company's value creation prospects.
- Companies can increase earnings and simultaneously destroy value if the investments the company makes don't earn an appropriate rate of return.
- Second goal of financial statement analysis is to make a link between a company's strategy and how it creates value

- You can break ROIC into two components: profitability (net operating profit after tax/sales) and capital velocity (sales/invested capital). Companies with high operating profit margins and low capital velocity are generally pursuing what Michael Porter, a professor of economics, calls a “differentiation” strategy. Companies with low operating profit margins and high capital velocity are following a “cost leadership” strategy. The analysis of how a company makes money spills directly into an assessment of how long the company can sustain its advantage (if ROICs are attractive) or what the company has to do to improve its economic profits.

#2: Understand value (the present value of free cash flow)

- present value of future free cash flow determines the value of a financial asset. This is true for stocks, bonds, and real estate. Valuation is challenging for equity investors because each driver of value—cash flows, timing, and risk—are based on expectations whereas two of the three drivers are contractual for bond investors.
- “Remember, cash is a fact, profit is an opinion.”

#3: Properly assess strategy (or how a business makes money)

- The idea is to distill the business to the basic unit of analysis. For example, the basic unit of analysis for a retailer is store economics.
- The classic approach is to analyze the industry and how the company fits in, and the common tools include the five forces that shape industry attractiveness, value chain analysis, assessment of the threat from disruptive innovation, and firm-specific sources of advantage.

#4: Compare effectively (expectations versus fundamentals)

- one that distinguishes average from great investors, is between fundamentals and expectations
- Making money in markets requires having a point of view that is different than what the current price suggests.
- Rather than asking whether this turnaround is similar to a prior turnaround, it is useful to ask for the base rate of success for all turnarounds. (ask inverted questions, not the same questions everyone else asks).

#5 Think probabilistically (there are few sure things)

- Great investors recognize another uncomfortable reality about probability: the frequency of correctness does not really matter (batting average), what matters is how much money you make when you are right versus how much money you lose when you are wrong (slugging percentage).
- If the goal is grow the value of a portfolio, slugging percentage is what matters.

#6 Update your views effectively (beliefs are hypotheses to be tested, not treasures to be protected)

- Great investors do two things that most of us do not. They seek information or views that are different than their own and they update their beliefs when the evidence suggests they should.

#7 Beware of behavioral biases (minimizing constraints to good thinking)

- Warren Buffett captures this idea when he distinguishes between an engine's horsepower (IQ) and output (RQ):
  "I always look at IQ and talent as representing the horsepower of the motor, but that the output—the efficiency with which that motor works—depends on rationality. A lot of people start out with 400-horsepower motors but only get a hundred horsepower of output. It's way better to have a 200-horsepower motor and get it all into output."

#8 Know the difference between information and influence

- Prices also provide useful information in capital markets. The main value is as an indication about expectations for future financial performance.
- prices can go from being a source of information to a source of influence

#9 Position sizing (maximizing the payoff from edge)

- Puggy Pearson was a cigar-chomping gambling legend who won the World Series of Poker and was one of the world's best pool players. When asked about his success, Pearson said, "Ain't only three things to gambling: Knowin' the 60-40 end of a proposition, money management, and knowin' yourself."
- Great investors take to heart all three of Pearson's points, but money management is the one that gets the least attention in the discourse on investment practice.
- Success in investing has two parts: finding edge and fully taking advantage of it through proper position sizing

#10 Read (and keep an open mind)

- enough said on point #10

These are the points that I took, but read it for yourself and see how it speaks to you.

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My hope is that all who across OSV will become Investing Superpowers.