Stock Picking Junkie

The Ultimate Guide To Value Investing

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Introduction

1.1
Our purpose

We the founders of StockPickingJunkie.com believe there are logical steps behind every task or process. When we turned our attention to the stock market, we began to look for clear methods to find the best stocks to buy. We realised very quickly that day trading & FX is a fools game with no true data driven process behind what goes up and what goes down. So we narrowed our investment strategy down to long term investing.

Chapter one

The first book we came across that began to identify investment opportunities based on company strength was Benjamin Graham's "The Intelligent Investor". Ever since, our investing technique has been built around value investing. Benjamin Graham brought logic and process to the madness that is the stock market.

Over time, we have enhanced our strategy through reading and experience. We incorporated learnings from Warren Buffett, Michael Burry and many others. Having seen success in finding the best stocks to buy, we wanted to share our strategy with you. StockPickingJunkie.com is an educational tool to help you make wise and responsible investment decisions. In the words of Warren Buffett "the first rule of investing is not to lose money".

Our value investing guide will be plain, simple and easy to follow.

1.2
What is value investing?

Value investing is finding strong companies at attractive prices. But why would a strong company be available at an attractive price? The most common reason is short term profit disappointment. If you can prove that the respective company is in a healthy position and the short term profit drop is merely a blip, you may find yourself with an opportunity to buy a strong company at an attractive price. Short term volatility is what creates opportunity for the long-term investor.

If you are looking for a logical, data driven process of finding the best stocks to buy then Value Investing is the strategy for you.

1.3
Value investing mindset

- Value investing requires patience, you need to hold investments long term.
- Value investing needs a thick skin, you will be buying when everyone else is selling.
- Value investing needs an emotionless investor, let the numbers make the decisions for you.
- Do not indulge in staring at the stock market every second. Act as if the whole stock market does not exist. Your only interest is the business you are researching to invest in.
- Invest in a business-like manner. Having a business mindset when investing will give you the discipline to commit your money to an investment only when it makes sense from a business perspective.
- Value investing should tell you more about what not to buy then what to buy.

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Chapter **two**

The companies we look for

We invest only in excellent businesses that have expanding value. We believe time is a friend to a great business and an enemy to a poor one. For a company to expand into the future it needs certain qualities. To identify them we must answer the following:

1) Does the company have a clear consumer monopoly?
    - Is there a brand name product, a key service, or some attribute that makes people or businesses dependant on the company?
2) Are the earnings of the company strong and showing an upward trend?
    - What is the company's earnings per share (EPS) trend over the past 10 years? Is it growing consistently upwards or fluctuating wildly?
3) Is the company conservatively financed?
    - A consumer monopoly should be making huge amounts of cash. It should have little or no long term debt. If debt is present due to the acquisition of another company make sure has acquired a consumer monopoly.
4) Does the business consistently earn a high rate of return on shareholders' equity?
    - How well are management using company assets? A consistently high return on shareholders' equity is the clearest indication of a strong management team.
5) Does the business get to retain its earnings?
    - How much is the company paying out as dividend in relation to earnings? If most of the earnings are being paid back to shareholders the company will never reinvest to grow.
    - Does the company pay back earnings when there are no investment opportunities available? If so then you can be sure that the management team are acting in the best interest of shareholders.
6) How much does the business have to spend on maintaining current operations?
    - Is a huge amount of company revenue spent on capital expenditure to maintain current operations? If so the company will have no surplus cash to ever grow the company.
7) Is the company free to adjust prices to inflation?
    - An excellent company is one that is free to increase the prices of its products in tandem with inflation, without experiencing a decline in demand.

Given the above, we always avoid commodity-type businesses. These are businesses that sell a product whose price is the single most important factor in the consumers buy decision. Typical commodity-type businesses are; textile manufacturers, producers of raw foodstuffs, steel producers, energy companies, paper manufacturers, lumber industry.

The below characteristics are inherent for such companies and is why they will never generate superior profits:

- Low profit margins
- Low returns on equity
- Difficulty with brand name loyalty
- Presence of multiple producers
- Erratic profits
- Profitability dependant on management's ability to efficiently utilise tangible assets.

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Chapter three

Finding the best stock to buy

The analysis process aims to find the best companies to invest in. The data that forms the basis of our analysis is extracted from freely available company financial statements. We accumulate data across a ten year time horizon. Our analysis is a mixture of both quantitative and qualitative investigation.

Our goal is to find how well a company has performed and been managed and determine whether past performance trends will continue into the future. No one can predict the future. By analysing the past and researching a company's current state, we can generate a level of confidence that future performance will be strong. We have already outlined the characteristics we are looking for in a company (see Chapter 2).

Our analysis process aims to give us a high degree of confidence in our investing decisions.

3.1
Which stocks should you analyse first

There are millions of stocks. Going through and analysing each one would be impossible. You need a method of filtering down the number of stocks you want to analyse. We accomplish this in two steps.

Michael Burry's filtering mechanism

Michael Burry, the famous investor who predicted the housing crash came up with a method that we have adopted. As an investor, especially a value investor, you want to buy stocks when they are unpopular and ride the price wave upwards. The following rule allows us to filter for stocks that are currently unpopular:

- Only analyse a stock whose current price is within 10-15% of the 52 week low price.

By filtering for stocks whose current price is close to its lowest price over the past 52 weeks, we are cutting our analysis down to stocks that are currently unpopular. This method helps to narrow your potential investments at any given moment in time.

Qualitatively filtering for consumer monopolies

Historically, there are three types of businesses that form consumer monopolies:

1. Businesses that make products that run out, have brand name appeal and that sellers (e.g. Tesco) have to carry or use to stay in business.
   - Brand name appeal is key to products that run out fast. Consumers look for certain brand name goods. Supermarkets, in order to satisfy customer needs must have these brand names on their shelves. This gives the manufacturer the pricing advantage. It can set a single price that the merchant has to pay. This does not just have to be consumer goods. It can be pharmaceutical drugs with patents, restaurant food chains with location advantages etc.
2. Communications businesses that provide a repetitive service manufacturers must use to persuade the public to buy their products.
   - In order for a manufacturer to create demand for its product it must advertise. Multinational advertisers have a unique advantage where they can support multi-national enterprises advertising needs. Therefore, they have a service a manufacturer always needs.
3. Businesses that provide repetitive consumer services that people and businesses are constantly in need of.
   - These companies provide necessary services but require little in the way of an educated workforce or capital expenditures. Typical companies include credit card companies, pest control etc.

Through research, you must decide whether a company falls into one of these categories or not. This should be your next step in selecting which companies you want to analyse further.

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Finding the best stock to buy

3.2

Analysing a company

Our analysis consists of a series of tests which should identify any issues we may potentially have with a company. If a company can pass all the tests, we have a strong consumer monopoly that is a perfect investment candidate.

3.2.1

Does the company have consistent earnings growth?

A great way to quantify how consistently a company has grown is by calculating its growth quality.

$$Growth\ Quality\ (\%) = \frac{Number\ of\ (Rev\ Increases + EPS\ Increases + DPS\ Increases - Losses)}{27}$$

Rev Increases – Count the number of revenue increases in the last ten years
EPS Increases – Count the number of earnings per share increases in the last ten years
DPS Increases – Count the number of dividends per share increases in the last ten years
Losses - Count the number of annual losses in the last ten years

By comparing year on year changes in revenue, earnings and dividends, growth quality gives a good indication of how consistent overall growth has been over the last ten years. We have found that a growth quality greater than 60% helps to filter companies which have grown in a monopoly-like manner.

3.2.2

Are the earnings of the company strong?

There are two methods that we use to determine how fast a company's earnings have grown over the last ten years. We recommend performing both calculations and comparing results.

Earnings per share annual compounding growth rate (Ten year horizon)

EPS Growth rate calculates how fast a company's EPS is growing per year. We look for a growth rate that will exceed inflation whilst comfortably covering the costs of trading commission and capital taxes. This requires a compounding EPS growth rate of 7%.

$$EPS\ compounding\ annual\ growth\ rate\ (\%) = \left[\frac{CY\ EPS}{(CY - 10\ )EPS}\right]^{1/10} - 1$$

CY = Current year results

Warren Buffett's owner's earnings compounding growth rate (Ten year horizon)

Warren Buffett's method of evaluating how a company has grown its earnings is simple. He only considers the factors of revenue that directly puts or takes cash into/from the pocket of the shareholder. Any revenue drivers that do not put or take cash into/from the owners pocket are eliminated. This adjusted earnings value he called owners earnings (OE).

$$OE\ compounding\ annual\ growth\ rate\ (\%) = \left[\frac{CY\ OE}{(CY - 10)\ OE}\right]^{1/10} - 1$$

$$Owners\ Earnings = Net\ Income + Amoritisation + Depreciation - Nomal\ capital\ expenditures - cost\ of\ granting\ stock\ options - unusual\ non\ recurring\ expenses - income\ from\ companies\ pension\ fund$$

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Finding the best stock to buy

Similar to EPS compounding annual growth rate, we are looking for an OE compounding annual growth rate of 7% to break even on our investment.

3.2.3

Is the company conservatively financed?

The single largest liabilities for most companies are its interest borrowings and its pension liabilities to employees. Excessive debt can lead to serious issues for a company down the road.

Chapter three

Pension Deficit and pension liability

It is important to check how much pension a company owes to its employees. A high pension deficit in comparison to yearly earnings could cause serious financial issues down the road. As a rule of thumb we want a company's:

- Pension deficit to be less than one year's post tax profit
- Pension liabilities to be less than five times post tax profit

Interest borrowings position

We have two tests of a company's debt position. The first test looks at the company's debt position in relation to post tax profits. We class a manageable debt ratio as anything less than 5 where:

$$Debt\ Ratio = \frac{Total\ interest\ bearing\ borrowings}{5\ yr\ avg\ post\ tax\ profits}$$

The second test assesses the company's debt burden relative to shareholder equity.

$$Long\ Term\ Debt\ Ratio\ (\%) = \frac{Long\ term\ interest\ bearing\ borrowings}{Total\ Assets - Total\ Liabilities\ (Capital)}$$

The company is in a manageable debt position when long term interest bearing borrowings are less than 50% of the total company capital.

Quick ratio

The best test of a company's liquidity is to compare its current assets against its current liabilities.

$$Quick\ Ratio = \frac{current\ assets}{current\ liabilties}$$

A company with 1.5 times more current assets than current liabilities is sufficiently liquid enough to get themselves out of trouble if things take a sudden turn for the worse in the short term.

3.2.4

Can the company maintain its dividends?

By comparing the difference between earnings and dividends per share, we can identify how much margin of cover a company has on the dividends it currently pays out.

$$Dividend\ Cover = \frac{Total\ ten\ year\ EPS\ (sum)}{Total\ ten\ year\ DPS\ (sum)}$$

A dividend cover of 2 provides comfort that the company can continue to pay out dividends at current rates.

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3.2.5

Does the company spend excessively on replacing/maintaining assets?

A company that spends a large amount of their net profits on capital expenditures leave nothing for growth and reinvestment. The CAPEX ratio compares capital expenditure against post tax profits.

$$CAPEX\ Ratio\ (\%) = \frac{10\ year\ average\ capex}{10\ year\ post\ tax\ profits}$$

We want capital expenditures to be less than 50% of annual post tax profits.

3.2.6

Has the company purchased any other companies?

It is important to understand whether the company have recently purchased another company. If a company's mergers and acquisition costs are greater than one year profits you need to do some researching. If the company has purchased another consumer monopoly you should be happy. However, if the company has purchased a commodity-type business, you need to be extremely worried. Consumer monopoly and commodity type mergers rarely work. In the long run this could have a huge impact on the company's profitability.

3.2.7

What return are management generating on shareholder money?

It is vital to understand how well management are generating money. This will have the largest single impact on future growth and profitability. There are two quantitative tests we do to assess how well management have done in the past.

Return on capital employed (ROCE)

ROCE quantifies how a company has used its assets to generate profits.

$$ROCE = \frac{Post\ net\ profit}{Capital\ Employed}$$

$$Capital\ employed = Fixed\ assets + Current\ assets - Current\ liabilities$$

You should calculate ROCE every year for the past ten years. An average ROCE greater than 7% would imply that management has used assets well enough to generate returns that would comfortably withstand the effects of inflation.

Return on Equity (ROE)

ROE determines how well a company has used shareholders money to generate profits.

$$ROE = \frac{Post\ net\ profit}{Shareholder\ Equity}$$

Similar to ROCE, you should calculate ROE every year over the last ten years. The average company has an ROE of 12%. We are looking for companies with an average return on equity greater than 15%.

A company has two choices with regard to how it uses its earnings. It can either pay the earnings out as dividends or reinvest the earnings to increase the underlying value of a company. We believe a company should only retain its earnings if it is confident it can generate a return greater than the investor could get with the money he would've received as dividends. If ROE is greater than 15% you would want your money to stay with the company and not be paid out as dividends. This is because the compounding effect will increase your initial investment at the ROE rate.

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Chapter four

Important points to note

4.1
Understanding investing taxation

It is important to understand the effect taxation can have on your investments.

- When a company pays out dividends on stock you own, you will be liable to pay income tax on this. The amount of tax you pay will depend on what overall tax bracket you are currently in e.g. 20%, 40% etc.
- When you sell a stock you own, you will be liable to pay capital gains tax on the profit you have made. This varies from country to country.

4.2
Stock diversification

"Diversification is something people do to protect themselves from their own stupidity" - Warren Buffett

As business perspective value investors, we need to know our investments inside out. It is only possible to effectively know and manage a few companies well. Given that we are looking for consumer monopolies at great prices, once found we would want to hold for as long as possible.

From experience:
- At a maximum you should hold no more than 30 investments in your stock portfolio. Any more would be extremely difficult to manage.
- You should have more than 10 to ensure you do not have all your eggs in one basket.

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Chapter five

Get in touch

Our website stockpickingjunkie.com has:

- Tons of great articles on our strategy and investing principles
- Stock research we have conducted on companies across the UK and US stock markets

We would love to engage with you on everything we write. Your feedback on our strategy would be awesome! If you have any queries, comments or advice feel free to get in touch via email: cmpsj01@gmail.com.

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