The STAR Guide to Equity Investment

Section 5 – Lessons from the Maestros

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5 Lessons from the Maestros

The role of equity investment in the wider planning of your finances

We wish to re-emphasise at the start of this section that the first priority is for you to decide on the place of equity investment within your overall financial planning strategy. If you are in any doubt about this, all the available advice stresses that you should discuss this vital planning aspect with a qualified adviser who is able to help with all legal and taxation factors relating to a balanced overall strategy. If you are considering share investments, choose your strategy and components with care. It is vital to take account of a few key variables. These include:

- Personal and family financial priorities
- Attitude to risk
- Personal interest in investment per se
- Ultimate investment objectives
- The amount of time that you are able, and wish, to spend on investment selection and management

Distinction between *Trading* and *Investing*

Before delving into the specific details of company share analysis it is important to distinguish between the factors that relate to decision making for short term trading and those used for longer term portfolio investment.

Trading

Traders tend to focus on the technical market forces that move share prices in the short term. In the days before the globalisation and digitisation of the financial and investment world the short term was defined in days or possibly hours but in the 21st century the large active professional traders often time their deals in seconds or even nanoseconds.

It is not the intention of this Guide to delve in any detail into the vast range of data and signals that are used by market traders. These range from the traditional study of charts that trace the movement in prices of shares, commodities, currencies and other traded items to the use of highly sophisticated algorithms for dealing in a wide range of equity related assets and derivatives. As an increasing number of market participants such as hedge funds and private equity groups have joined the established trading groups the short-term forces operating in international markets are exerting more and more influence on the movement in prices.

In addition to the pricing signals already mentioned, these market operators also follow the strength of short selling positions (the number of shares that have been sold by traders who have “borrowed” them from existing owners in the expectation that the price will fall so that they can buy back later at a lower price) and all other factors that are likely to influence the short-term movements in share prices including corporate and sector news releases. As both the UKSA and the STAR screening processes focus on longer term investing this Guide does not feature the separate signals used by traders.

Investing

This Guide concentrates on the chief methods that have been developed and employed by successful investors to generate longer term results that outperform the basic indices. The analytical methods that we describe primarily relate to the two fundamental approaches used to filter out the most promising candidates for investment namely, Value investing and Growth investing. The Guide will also touch on alternative aspects of the "Investosphere" such as Momentum Investing, short selling and the expanding field of ESG (Environmental, Social and Governance) criteria as all these forces impinge on the wider valuation metrics.

Learning from highly successful professional investors in the USA and the UK

In the USA the essential elements of the value methods of assessing investments grew out of academic and practical investment research carried out by the American economist and investor **Benjamin Graham**. His work, in the first half of the 20th century, highlighted the importance of seeking out businesses that could be bought below their intrinsic value. One of Graham's best-known pupils is the highly successful investor **Warren Buffett** who, together with his partner **Charlie Munger**, has achieved consistently high returns for investors in Berkshire Hathaway, his listed investment business. However, Buffett admits that he has had to adapt Graham's key tenets as conditions alter.

The list of useful guides to successful investing also includes other Americans such as **Mike Lynch, John Templeton** and **T Rowe Price** who have made large amounts of money for themselves and their clients by following the same basic tenets that were pioneered by Graham. More recently names from across the pond include **Joel Greenblatt** who popularised the Growth at a Reasonable Price (GARP) approach through his book entitled "The Little Book that Beats the Market". His selection screens filtered out companies for investment that combined a high return on invested capital with a low valuation. More details on the Greenblatt GARP screens in section 7.

In the UK, which is of course a much smaller market than the USA, success has been chalked up by Anthony Bolton, who like Mike Lynch was also a Fidelity manager, and made his stock-picking name running the Fidelity Special Situations fund. However, a much earlier successful investor was **John Maynard Keynes**, the early twentieth century academic and public sector economist whose eponymous economic theories helped national economic recovery but who was also a high achieving investor for his university college and his personal wealth.

Another name from few decades ago is that of **Jim Slater**, an accountant and keen investor and writer, who made his mark as a successful professional stock picker, for a limited period in the second half of the twentieth century, with his book "The Zulu Principle" and his listed company Slater Walker Holdings. His main contributions to investment analysis were the concept of the PEG Ratio which measures a company's Price Earnings Ratio divided by its annual earnings growth rate and the publication of data for private investors cleverly entitled "Really useful Financial Statistics" otherwise known as REFS.

Turning to the twenty-first century, **Terry Smith**, who initially made his name with his book "Accounting for Growth" that was published in 1992 and criticised the growing practice of creative accounting, has created wealth for investors with his Smithson funds. Even more recently investment manager James Anderson who adopts much more growth-oriented policies at investment managers Scottish Mortgage has proven to be a highly efficient wealth creator with his global growth-focused strategies.

Benjamin Graham

Often referred to as the father of value investment Graham was both a highly respected British-born American academic economics professor and a successful practical investor. It was Graham who, in his widely read books “The Intelligent Investor” and an earlier book “Security Analysis”, set out the objective of seeking out intrinsic value when selecting stocks for investment.

Graham peppered his writings and lectures with pithy aphorisms about investment. These focused on the need for undertaking sound research and analysis highlighting one-liners such as “**buy not on optimism but on arithmetic”** and “**never delude yourself that you’re investing when you are speculating”** and **“individuals who cannot master their emotions are ill-suited to profit from the investment process”.** He also opined that **“Businesses, organisations, financial institutions and regulations may change but human nature remains the same”.**

Continuing in the same vein he commented that **“people who invest make money for themselves while those who speculate make money for the brokers”.** It was Graham who advised investors to **“buy when both the experts and the crowd are pessimistic and sell when they are optimistic”**. This latter point has been repeated by both warren Buffet and John Templeton.

One may well question how successful Graham was as an active investor. According to various press reports his funds achieved average annual gains of approximately 20% in the twenty years from 1936 to 1956 against index gains over the same period of 12%.

Peter Lynch

The reason that Peter Lynch is included in many lists of successful investors is that under his management the Fidelity Magellan Fund grew the value of an investor’s $1000 in 1977 to $28,000 by 1990. He explained the reasons for this success in his book entitled “Beating the Street” that was published in 1993 and his basic investment philosophy that powered his success in his first book “One up on Wall Street”. Over this period of 13 years he managed to achieve average annual fund gains for investors in his Magellan Fund of just under 30% against the US market benchmark gains of little more than 3%. This is a phenomenal achievement as he has beaten “The Street” as he calls the wider market by more than 25 percentage points over a 13 year period. However, the timeline for his record is a lot shorter than that of his peers that are summarised in the chart below.

Peter Lynch

Although Peter Lynch is not as well known in the UK as US-based investment stars like Buffet, Soros and Templeton he represents a successful professional investor who was able to retire from Fidelity at the very young age of 43. However, it should be noted that the main reason for this early retirement was that he realised his life was totally taken up with investment to the detriment of his family. Even in the 1970s and 80s he had been putting in long office hours, usually starting soon after 6am and often working at weekends.

Lynch's success can be nailed squarely on his commitment to hard work and continual study of all aspects relating to the companies in which his fund was buying, holding and selling and summarised by his injunction "to invest in what you know".

Warren Buffett

It is probably fair to say that Buffett has become a legend among a large number of private investors and even non-investors, for his ability to grow the value of his quoted investment fund Berkshire Hathaway over longer periods than other fund managers. Like his mentor Graham, Buffett is regularly quoted in the press and online for his pithy home-spun comments about investment.

Warren Buffett

His basic methodology is fundamentally not too dissimilar to that of Graham, his early mentor, as he targets the key corporate financial metrics starting with the **return on equity (the company's net income divided by total issued equity)** and this is evaluated over at least the past 5 years in order to get a valid picture of the strength of the underlying business. An important component of the income measure is, in turn, the **operating efficiency as determined by dividing net income by net sales**. In terms of fundamental strength, the **pricing power of the business or what Buffett terms competitive advantage** is also important for generating increasing profits in the future so he steers away from commodity producers who are usually what are termed price takers, unable to influence the final price of their product in a competitive environment.

A further vital measure is the amount of borrowing with a **low debt to equity ratio (total liabilities divided by total equity capital)** preferred. Having done the basic analysis Buffett's ability lay in his, and that of his partner Charlie Munger, to determine the cheapness of the business, rather than the share price, by **calculating its intrinsic value** (shades of Graham) and comparing this to the market capitalisation (the number of shares in issue multiplied by the current share price).

So, having outlined Buffett's basic investment philosophy and methods it is valid to ask how successful he has been. I have researched the price of his Berkshire Hathaway fund since 1980 and compared that to the index value of the S & P Index over the same period and discovered that the index gained on average just under 9% annually over this forty-year period while the share price of Berkshire Hathaway climbed by just under 20% each year over the extremely long period of 40 years. To beat the market over such a long period is amazing as it covers varying economic and financial cycles thus requiring a degree of stability and perseverance in the investment decision making process that has been un-matched by other professional managers.

Joseph Piotroski

Chicago University's Professor of Accounting Joseph Piotroski is included briefly in this section because he developed a system for evaluating stocks that was based on nine accounting criteria covering three corporate accounting categories dealing with **Profitability**, **Monetary measures** such as cash resources and borrowing levels and **Operating Efficiency**. This system became known as the Piotroski Score with shares rated 8 or 9 being the most attractive while those rated with 2 points or less considered poor value.

The reason I include Piotroski in this section is that in a paper he published in 2000 Piotroski demonstrated that when he back tested his evaluation system between 1976 and 1996 this scoring system would have returned no less than 26% annual growth in this 20-year period. In order to achieve this high return the investor would have had to purchase stocks scoring 8 and 9 while shorting those with scores of 2 or less. Furthermore, back testing is no guarantee that the performance in a particular period will be repeated in the future. The much longer period, of over 30 years, that the STAR screening methods have been operating proves that the efficacy of specific methods varies with changes in the broader economic and financial universe.

Anthony Bolton

One of the most successful UK-based professional investors in the latter decades of the twentieth century must surely be Anthony Bolton who enriched the fortunes of investors in his Fidelity Special Situations Fund by turning an investment of £10,000 in 1979 into almost £1.5m when he retired more than 20 years later.

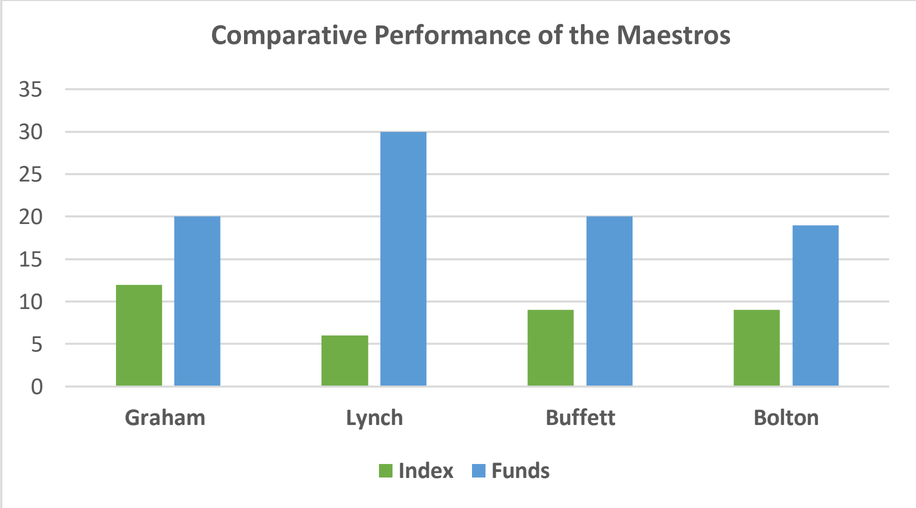
Anthony Bolton

Although Bolton never sought publicity regarding his investment selection methods he has mentioned a few key fundamental aspects of his investment methodology. As with many professional investors he always placed high value on personal meetings with the directors and management of companies that were potential or actual investment targets. He was also a believer in moving against the herd. In this respect he followed some of the methods employed by people like John Templeton who always professed to accommodate buyers in shares that he thought were over-valued and help out sellers in stocks that he thought were cheap. Unlike most successful long term investors Bolton found the use of charts and technical analysis useful as a support to fundamental analysis.

Bolton's success is clearly measured through the performance of his quoted fund and this shows that he managed to achieve a compound annual return over more than 20 years of 19% against the UK All Share Index return of 9% over the same period.

Summary of the Maestros' Performance

The chart below highlights the comparative performance of these successful investors and draws the conclusion that such consistent returns must contain lessons in investment selection that are useful for us all.



Applying the key lessons from these investment maestros

First of all, it is clear that none of the investors mentioned above has chalked up these long-run successes without a lot of hard work. The diligence that they have each applied to the task of selecting and subsequently managing portfolios of equities implies that it pays us all to think carefully about our basic objectives. We need to employ the most appropriate modus operandi to meet these aims while also being most suitable for our personal preferences. For those who do not wish to get closely involved in managing their investments directly it may well be preferable to select superior expertise to do this, always remembering that it is difficult to spot the Lynchs, Buffetts and Boltons in advance. For those who wish to be more hands on it is worth spending time in using most of the following specific analytical criteria.

Determining this intrinsic value requires careful research into the key financial and economic determinants of business success. These focus on:

- The strength and direction of both national and international economies
- The past record and likely future trends of industrial and commercial sectors within economies and increasingly at a global level
- The place of individual businesses within this wider global and sectoral context
- The total capital employed in the business
- The level of borrowing related to equity capital (gearing ratio)
- The overall efficiency of the business as measured by the return on capital employed
- The record of growth in sales as an indicator of business growth
- Business efficiency at the operating level as represented by operating margins (measured by sales less variable costs)
- Ownership measures that assess the proportion of annual earnings after deducting all fixed and operating costs that is available to; a) maintain the business (depreciation & amortisation) b) to expand it (R & D and capital expenditure) and c) pay the owners a dividend

In Section 7 we demonstrate how it is possible to develop an equity screening process that incorporates most of these key metrics in dynamic spreadsheets.