

## **Our 9-Step Investment Process – Part 2**

We now continue with the second installment of how we operate and run our investment management business. Following on from the first installment, we shall discuss these activities next:

### **4. Building the Financial Model**

- Understanding the detailed historical performance
- Gathering extensive information with our in-depth research
- Making our own estimates of future growth and profitability
- Assessing an initial value of the business based on discounted cash flows (DCF)

### **5. Reaching Out to Management**

- In-person meeting or conference call with the management team to see if their long-term vision for the business is in concordance with our assumptions and expectations
  - Do we trust management?
  - How do they plan on investing our capital?
- ✓ Move to next step OR
- x Discard the idea

### **6. Find the Optimal Risk-Reward Price**

- Stress testing the model to assess downside risk
  - Understanding value-creation catalysts
  - Testing scenarios on a 3-yr horizon
  - Identify an entry price with 50-100% upside
- ✓ If the price is right, start buying OR
- x If the price is not cheap enough: add to our wish list

We have explained to you the four concepts that drive our ethos, which are Independence, Concentration, Transparency, and Performance. Following from those drivers, we then have our ongoing nine-step methodology for how we actually decide what stocks to buy and what to leave aside. Our last installment discussed the first three steps, which are:

- 1. Our First Hurdles**
- 2. A Business Model that We Can Understand**
- 3. Discussing the Idea with the Team**

Each part of our process is a stepping-stone to the next, and we have developed this framework after combined decades of working in finance. (Again, in order to help us with the technical terms used hereafter, I will provide links for certain words that you can click to read on Investopedia, our preferred resource for providing accurate, financial definitions.)

#### **4. Building the Financial Model**

In the previous letter, we broke down how we begin our process, which closed with the team discussion about the stock under scrutiny. If we can get consensus as a group, then we proceed to dive even deeper into the company as we begin to model its future probabilities for good performance.

We want to understand the company's history and how well it has performed in the past, so we use the historical reports on revenue and growth, costs and expenses, while analysing it in the context of the industry wherein it operates. Our in-depth research means scouring all public resources for information, as well as researching every other related party in the company's orbit, such as employees, competitors, industry publications, and so on. Interestingly, it is when we start to dissect the industry and the competition that we sometimes unearth another stock that is even more attractive to us according to our investment parameters. So, it is in this phase that we might move on to another company if we prefer its potential for outperformance over time to the stock in question.

Once we have collated all that information, it is time to start plugging the data into various scenarios for the future to assess the upside and downside potential along with the probabilities of each one occurring. As previously stated, no one can know the future with certainty, but we can make our forecasts of the most likely outcomes. And we do not have to get this 100% correct, rather we just need to land on the correct side of upward growth or downward loss.

After we have assigned these probabilities of various scenarios happening or not, we can then plug in actual numbers into a Discounted Cash Flow model. Investopedia's definition states,

"Discounted cash flow (DCF) is a valuation method used to estimate the value of an investment based on its future cash flows. DCF analysis attempts to figure out the value of a company today, based on projections of how much money it will generate in the future." ([www.investopedia.com/terms/d/dcf.asp](http://www.investopedia.com/terms/d/dcf.asp))

As they explain, "The purpose of DCF analysis is to estimate the money an investor would receive from an investment, adjusted for the time value of money. The time value of money assumes that a dollar today is worth more than a dollar tomorrow."

If the DCF model works out to deliver more money in future than it costs us to invest today, then it is a worthwhile investment to consider. This sounds patently obvious, but there are not too many ways to calculate such figures, hence why the DCF model is such a popular framework. Again, there are not perfect answers here, but this method is very powerful because it accounts for the company's prospects for making money in the future and it can give powerful insight into the probabilities for success. If the DCF number is promising, then we can move on to the next step.

#### **5. Reaching Out to Management**

If we are comfortable with the stock's valuation and growth prospects for the future, we then want to speak with the company's management to get an understanding of who they are, how they think and operate, what they have to say about the actual numbers they report, how they describe their strategic plans for future results, and how they plan on investing the corporation's capital.

Companies that trade on the stock exchange have to file quarterly reports, i.e. they report their numbers every three months, and deliver their audited earnings statements to the public. Along with those reports come conference calls and shareholder meetings, when folks like us can grill the executives on what happened and what they think will happen next. One element of this is a question of personality, whereby sometimes we just cannot get comfortable with the C.E.O. or chairperson - or any significant shareholder with executive control - who does not work for the good of all shareholders. This aspect sounds a bit vague and amorphous, however meeting the people behind the numbers yields terrific insights about how things will unfold down the line. If we are not confident in their ability to truly do what they say, then the

chances are high that we will discard the idea and move on to something else. As with most things in life, this comes down to a matter of trust.

## 6. Finding the Optimal Risk-Reward Price

If we get to this stage and we are still interested in the company's story, its management team, and its prospects for growth above today's price, then we continue building out our financial model to determine the upside/downside of what the company can be worth in various scenarios. This is how we begin to calculate what is exactly the price at which we will start buying the company's shares. As we openly state on our website,

We focus on a smaller number of securities to allow us to gain a solid understanding of the companies and identify their risks. This work reduces the chances of making errors and suffering a permanent capital loss.

However, even though we prefer to keep things small and reasonable and manageable, we still have massive amounts of work to do with just the few stocks we buy and sell every year. In fact, when you consider how "concentrated" our portfolio is with 20 or fewer stocks, it is this anecdote from 2016 that we at Tonus Capital love to share with our clients and readers,

In November 2016, Philippe Hynes took the students from his Equity Investing class at Concordia University to Omaha, Nebraska to meet the Sage of Omaha, aka the legendary investment guru, Warren Buffett. While at lunch, the students were welcome to ask questions, the most insightful of which was, "Mr. Buffett, if you were wiped out financially, with only (only!) \$1 million dollars left to invest, how many stocks would you buy?"

To which he quipped, "About four or five stocks total, and I'd be back on top in a few years."

Only four or five stocks! Amazing to consider how the greatest investor alive would use such a simple and concentrated portfolio to start all over again. We do not profess to be level with his unrivalled skills, but his response is the perfect example of how straightforward this work is when you keep things under control.

This should give you confidence in our approach when you see it is also how the all-time best, Mr. Buffett, works at deciding what to buy and hold.

Since the financial crisis, you may have heard mention of "stress tests" for banks, which involves government regulators conducting exercises to see how each major bank will perform if the economy crashes. We conduct the same drills with our theses. This involves metrics like interest rate movements up or down, sales and revenue falling precipitously, industry setbacks, etc.

Alternatively, we also want to consider what factors might add value and send the share price upward. Does the company enjoy barriers to competitors entering the market? Are there favourable government regulations? Is the company in question a dominant industry player with certain prime mover or economy-of-scale advantages? All of these catalysts are important for determining how the future will unfold for the stock.

We are patient investors, much more so than the typical stockpicker today, hence scheduling our expectations across a three-to-five-year horizon. In practice, this is too long for most people who have a

very hard time waiting for even one year to pass. But this is what we mean by “discipline” and we work hard to educate people about this singularly crucial characteristic, i.e. patience for years and years.

However, mere patience alone will not win out often enough for us, so there is one more protection we build into our practice, which involves hedging downside risk. And how do we do that? Again from our website,

We retain a margin of safety, which we consider essential. We define this as the difference between the trading value accorded by the market and the intrinsic value based on our analysis. The lower the trading price compared to our valuation, the greater the margin of safety, which provides added protection if our initial hypotheses proves overly optimistic.

For example, after conducting our deep research and working to complete our extensive modelling, we might conclude that the company’s shares are intrinsically worth \$100 each. We might then determine that \$50 is the attractive price for us to start buying these stocks. The text box above explains that if we buy at \$50/share, we can only lose that finite amount over an extended period of time as the share price should eventually converge towards its intrinsic value of say, in this example, \$55/share. However, if we break our code and buy in at say, \$60 a share, our “margin of safety” is much smaller. The tricky part, obviously, is making sure that you have a sensible and achievable “intrinsic value” from which you begin your decision-making. We believe that we do this work very well.