At Focus Capital Management we focus our time and our research on a few select opportunities, so as to concentrate on our best ideas and avoid diluting our results with investments that are only mediocre or even merely good. This focus allows us to deeply research a company before investing, which typically takes between 1-3 months. Naturally, this leads to the question, what precisely are we doing with that time? What is involved in deep research? What do we examine in our quest to truly understand the company? And why is this deep research so important for investing successfully?

Ingredients of Deep Research

There are many different resources available to research companies. Not all sources apply equally to all companies, and some companies may have relatively few sources available at all. But even for little-known out-of-the-way companies, it is often surprising how much information is available if you dig for it. What follows are the necessary components of deep research for a typical company.

Financial statements

At the top of the list, of course, is the company's financial statements, going back for at least a few years. The true measure of a company will always reside in the financials. The company sells a product or service for *x* and it costs the company *y* to produce that product or service. After all expenses, overhead, taxes, etc., is the company making money and how much? It sounds simple, and it really is, but getting to the real answer is not simple at all. Often, the financial statements include various non-economic items that distort the picture. A careful investor has to reconstruct the financials so that they portray an accurate picture of the company and can be properly compared to other companies. This work is crucial and painstaking, but is relatively easy – it just takes work. (But be highly suspicious of adjusted numbers provided by management which often adjust for economic costs that should definitely be left in or various supposedly "one-time" costs that crop up every year!)

The financials are by far the most important source of information for a company. The basis of valuation for a company will always be the balance sheet, the income statement, and the projections for both these statements into the future. In addition, the financials provide a wealth of data with which to analyze and understand the company's inner workings. Are revenues stable, growing, erratic? How are margins? Strong margins are often indicative of pricing power and strong moats. Is there operating leverage? What is the capital structure and do they carry too much debt? Is the net income showing up in the cash flow or is it somehow dissipating into the ether? What is the business model? Who is the customer? Do they have high customer concentration? High supplier concentration? All this and more can be found in the financial statements and surrounding commentary. The focus and precise questions that need to be asked change from company to company, but the start of all deep research is the financial statements.

Quarterly calls and presentations

Another rich lode of information is the conference calls that most companies host to discuss quarterly results. Listening to these going back a few years is very useful. They give a good idea of what drives results for the company over time. They sometimes offer key metrics not found elsewhere. And they also give flavor on the competence of management. Does management do what they say they're going to do? Is management's guidance accurate? Does management hype new initiatives and then quietly drop them, never to talk about them again? Do they exhibit long-term planning and follow-through?

Competitors and industry

It is crucial to not focus solely on the target company while wearing blinders for the world around it. Researching a potential investment includes researching competitors and other industry players to a greater or lesser degree. If these companies are themselves publicly traded and have publicly available financial statements, an investor can learn quite a lot from them, but even for private companies some information is usually available. Researching the surrounding companies gives you a broader context within which to understand the target company. Do the different companies have the same business model or competing business models? Is the whole industry expanding or does their success depend on fighting each other for each point of market share? Are they insulated from each other geographically or in sub-niches? This research also helps give a yardstick with which to compare and contrast business metrics.

Studying competitors also provides a useful sanity check as for what valuation can be expected from the target company. An investor must avoid falling into the trap of relative value, buying a company because it is undervalued relative to peers, even if it's not necessarily undervalued on an absolute basis. At the same time, if the company appears undervalued on its own but is fairly valued relative to peers, the investor must consider if indeed the whole sector is undervalued or if there is something about the underlying economics that he is missing.

Supplementary materials

Depending on the company, all sorts of supplementary sources can be used to further research the company. Lawsuits, even if peripheral and unimportant in and of themselves, often reveal fantastic nuggets of economic information. For a pharmaceutical company or a biotech, medical journals publish clinical trials of their finished and in-process products as well as competing products. Government statistics can often be useful to measure market size and other relevant information. For some companies, bills of lading can reveal detailed real-time and historical data on their imports and exports. Depending on the company, you may find reviews for their products and services. News reports often include otherwise unpublished economic nuggets as well as interviews with founders or company management. All this information and more add to the total picture and help underpin analysis of the company's past and future.

Narrative

The most difficult, yet most important, area to research is the qualitative description of how the company makes money, its business model, and its competitive positioning. Often derided as "narrative" or "story", this is the real-world reality that underlies all the past financials and future projections. *You need to understand what makes the company tick and what makes it special.* This qualitative, squishy, somewhat subjective analysis is what decides their future growth, the resiliency of their moats, risk – all the truly important questions. Almost always, if a mistake in choosing an investment is made, this is where the mistake lies. It is not all that difficult to analyze financials and decide on a "fair" value for the company and whether it appears to be undervalued. But whether the past is harbinger of the future or whether new risks and fault lines will crop up to tear apart the past and present financials depends entirely on the real-world reality that underlies these financials and whether that real-world reality is in danger of changing.

Time

The most important ingredient is time. Don't just read. Don't just sift through. Don't even just analyze and dissect. You must also mull over, digest, and let percolate all the information that

you are reading, sifting through, and analyzing. Sit on it, sleep on it, turn it over in your head. Do not rush into a hasty decision that you will later regret. Think it over, come back to it in a few days, and think it over again. One of the truest signs of a real gem is that you find yourself more excited about it the more you think about it. And conversely, one of the biggest warning signs that you should heed is a company that you feel more lukewarm about the more you mull it over. Time brings clarity. Time brings depth. Time brings conviction.

Value of Deep Research

Why do we undertake all this deep research? What does all this extensive time and research gain and how does it make for better investments? We believe that deep research benefits investors in at least four ways.

Assures value

Deep research assures that the investment is truly undervalued. Often, companies that look undervalued at first or second glance have a rotten core or unattractive economics buried deep in the bowels of the company. And there are some companies which at first glance are fairly valued, but further research reveals to have secret and non-obvious sources of value.

Reduces risk

Deep research discovers and analyzes the various risks inherent in the company's business model. By delving deep into what makes the company tick and how it compares and contrasts to other similar companies, an investor can highlight what the major risks are and assess the likelihood of their occurrence and the severity of their effect if they should occur. Stress testing the investment against different possible futures is crucially important for successful investing. Remember, the first rule of successfully making money is not losing money.

Filters signal from noise

Deep research grants greater understanding and insight into the company, allowing future information and news flow to slot into place in the picture. By gaining a deeper understanding into what makes the company tick and what levers really move the company's business model, an investor gets a handle on which metrics and news are truly important signal and which are unimportant noise. It is not uncommon to see a stock react sharply to news that an informed investor would understand is not really important to the company's arc.

Builds conviction

Perhaps most importantly, deep research builds the necessary conviction to withstand temporary downturns in the stock, the stock market, the economy, or the business. If an investor only knows the company on a superficial level, he is liable to bolt at the first signs of trouble. When things go south, he does not have the tools to analyze if the downturn is temporary or permanent and whether the original investment thesis is broken. He never really had a deep understanding of the original investment thesis to begin with. But armed with deep research, a thoughtful investor understands the company's business on a deep level and can analyze whether something fundamental truly changed for the worse. Armed with well-founded conviction, he can persevere with the investment secure with the knowledge that he knows why he bought it and that the original investment thesis is still intact.

Deep Research is a Cornerstone of Focus Capital Management

At Focus Capital Management, deep research is a cornerstone of our investment philosophy. Our concentration in only a few positions at a time together with our long-term horizon and low turnover allow us to devote large amounts of time and research to each investment. Indeed, our commitment to deep research is one of the main reasons why the Fund is so concentrated to begin with. We believe that our deep research is integral to the Fund's long-term success since inception. As we like to say, "If you invest like no one else invests, you get results no one else gets!"