Idea Generation

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We are often asked about idea generation – how do we find good companies at great prices to consider investing in? With approximately 14,500 stocks to look at worldwide, where does one even begin to search? I recently read an article[1] that culled quotes from 50+ value investors on just that topic, and I would like to use that article as a springboard to discuss how we at Focus Capital Management approach this all-important topic.

The investors and managers surveyed can be generally grouped into three buckets or so:

1. Those who say they use screens of one sort or another,
2. Those who say they look for misunderstood niches,
3. Those who say they find great companies and then wait for them to fall in price and/or temporarily stumble, at which point they pounce.

At Focus Capital Management, we disagree with all three of these rigid approaches. We view idea generation quite differently, but nevertheless it can be very instructive to examine why we disagree with these other methods.

Method One – Screens

Some investors use screens to try to filter the vast universe of stocks for value stocks. Different investors may have a different set of metrics they prefer to focus on, but the common thread is that they rely on screens for a first pass through the investable universe to whittle it down to a more manageable list to look at.

On its face, using screens would seem to be quite reasonable. With dozens of financial metrics and ratios to choose from, you should be able to craft a targeted screen that encompasses precisely the type of company that you care to invest in. You can use this to chase a momentum or growth style of investing, and you can also use this to pursue a value style of investing. There is definitely something attractive to the idea of letting the computer do the work for you for the first round and then dig deeply into the remaining contenders.

However, we believe that relying on screens has three major issues. Firstly, the screen is only as good as the data the screen is built on, and quite often, the data is faulty. Sometimes, the data is just plain in error. Sometimes, the data is technically accurate but needs to be properly adjusted for various accounting oddities or one-time and/or non-cash effects. Sometimes, the data *is* based on adjusted (by management) numbers rather than GAAP accounting, which is even worse. Whatever the reason, if the data is faulty, then the screen will both filter out attractive opportunities and keep unattractive ones. Garbage in, garbage out.

Secondly, value screens tend to pick up a lot of terrible companies. Stocks that are cheap for a (good) reason. Screens just swamp you with bad ideas. We believe it is not a great idea to limit your investing universe to the specific universe of stocks that has an over-representation of companies that are liable to plummet or go bankrupt.

Thirdly, screens tend to miss a lot of great investment ideas. Even with all the different metrics, it is difficult or impossible to craft screens that reliably catch in their net the many different types of deeply undervalued companies – there is no one or two sets of metrics that describe these opportunities.

Method Two – Misunderstood or underfollowed niches

Some investors limit their investing universe to specific niches where they believe they will have an advantage. Perhaps turnarounds, or distressed firms, or spinoffs, or some other sort of special situation,

[1] http://latticework.com/idea-generation-for-intelligent-investors/

sector, or region. They believe that hunting in more sparsely inhabited areas will give them an edge over investors that play in the wider market. This approach has an intuitive sense to it, that looking where fewer people are looking is apt to bring greater rewards.

We believe, however, that this approach is based on a fundamental error. At their core, these investors are convinced that in general the market is pretty efficient, and therefore, you need a special situation or niche or *something* to explain why the market is getting it wrong. This is a major fallacy. We at Focus Capital Management disagree with the Efficient Market Theory in toto. Indeed, *most stocks are priced inefficiently*. Just look at the average swings from 52-week highs to 52-week lows on a typical stock. Does anyone really believe that the intrinsic value of the company is truly swinging as much? If you truly internalize the idea of the insane Mr. Market[2], you realize that the market is never rational (except by chance). It gets the price of a stock right every once in a while the same way a broken clock sometimes tells the correct time. But most of the time, the price of a stock is oscillating in a wide band around its true intrinsic value, from overvalued to undervalued and back. That doesn't mean that you can always be certain enough to take advantage of it in any random stock. But it does mean that there's no reason to limit your search to some niche or special situation or turnaround (which again tends to limit you to universes with a disproportionate number of poor investments). The need to find permission to believe is, in our opinion, a grave mistake that raises the level of risk and depresses returns.

In truth, run-of-the mill undervalued companies with reduced risk and favorable upside are *not* uncommon. You just need to find them. And when you do find a great company selling for significantly below a conservative estimate of intrinsic value, you do *not* need to search for a reason or excuse why it is so undervalued. That is just Mr. Market having one of its days. Accept it and profit.

Method Three – Look for great companies and wait

If you internalize our philosophy that Mr. Market often sends you irrational valuations (in both directions), this approach is a natural outgrowth. Identify your great companies, wait for the random market fluctuations to bring a particularly severe fluctuation downwards and voila!, jump in. You end up with a great company at a great price.

The problem is that if you pay attention to the practitioners of this method, you realize that they tend to have 100-250 such great companies on their watch list, which they're following and waiting to drop below their estimate of intrinsic value. That might work out okay, but that does not allow for the deep analysis and research that Focus Capital Management prides itself on. You cannot manage a concentrated portfolio of 5-10 investments and spend a month or more analyzing a company this way.

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[2] Mr. Market is a parable invented by Benjamin Graham, widely considered the father of value investing. In his seminal work, The Intelligent Investor, Chapter 8, Graham writes:

"Let us close this section with something in the nature of a parable. Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.

If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position. The true investor is in that very position when he owns a listed common stock."

Also, pre-selecting your estimate of intrinsic value and attempting to keep it updated over time as events unfold leads to many cognitive biases, including anchoring, confirmation bias, conservatism, and framing, among others. We prefer to evaluate companies on an up-and-down basis based on their current situation and prospects.

Our approach at Focus Capital Management

We at Focus Capital Management firmly believe that there is no rigid method to generate ideas that works consistently well. Rather, our approach to idea generation is founded on three principles: Read widely, pick up many stones, and triage quickly.

First, it is crucial to read widely. Different sources of ideas and different types of sources allows for varied and interesting opportunities to present themselves. Don't limit yourself to just one section of the investing universe or just one type of investing situation. What to read? There is no shortage of investment ideas, company profiles, and novel business models being written about. Keep your eyes and ears wide open. Certainly one idea to which we do subscribe is to read up on ideas from investors that you admire and follow your philosophy. (Technically, this isn't really idea generation because it doesn't address how those investors generated the idea, but let's not quibble.)

Second, pick up as many stones as possible for a quick look. The more stones you pick up, the greater the odds of your finding something interesting. You don't need very many investments to do well, but you *do* have to sift through very many investment ideas to find the few great investment opportunities that you can build on. A few dozen rejected ideas for each gem. In fact, it is really a few dozen rejected ideas for each idea that merits further deep study.

Third, triage quickly. Don't get bogged down on each investment idea thrown at you. You have to quickly winnow away the chaff to get to the kernel of ideas that deserve further research. Often enough, the investment idea is obviously unsuitable. Perhaps it deals with a conglomerate, whose multitude of moving parts makes it very difficult to reach a confident conclusion on its prospects and valuation. Ditto for a company that is too macro-focused (e.g. many commodity companies). Perhaps the company is a story stock, or a "turnaround" that has yet to start turning around, or just plain too expensive. Often, even the purveyor of the investment thesis himself only sees 20% upside, and frankly speaking, that is not nearly a sufficient margin of safety to be attractive. Sometimes, the thesis is just not convincing. The important point is to quickly dispose of the vast majority of ideas that just don't have the potential to be a great investment with the proper risk/reward profile.

By following this method of idea generation, you expose yourself to a large amount of ideas, many of them good and some of them excellent. You follow up on the most promising opportunities and the ones that look really attractive with the proper risk/reward profile are then researched fully.