Some evolving thoughts on research

Ahhh so sorry for the lack of posts. I mean to post on here ~once a week, but it’s always a struggle.

Why's it such a struggle? Say I research somewhere between three to five companies in a week and don’t like any of them. Should I still write about one? Why? What upside is there to me as the author to writing a negative piece on a company, even if it’s something as benign as “I think it’s fairly valued right now?” If the purpose of this blog is some combo of showing off (hopefully!) good research and looking for people to swap thoughts and ideas with, writing about stocks I’m not a fan of doesn’t really serve either purpose.

Aside from writing about companies I’m not investing in, the other thing I’ve thought about doing more of is putting up investing philosophy stuff, but the market there is pretty crowded. Does the internet really need another person saying, “buy a dollar for fifty cents” or “it’s probably a good idea to look at spin offs?”

So the combo of those two “don’t write” thoughts has left me with little to write about and a serious case of writer’s block.

But late last week I was doing a bit more work on Charter (disclosure: long through the Liberty complex) and texting with a friend about the cable industry in general when something hit me: I spend way more time these days reading transcripts to conference and earnings calls or industry publications then I do reading straight through 10-Ks and 10-Qs.

Now, I’m not arguing to stop reading company filings and just make investments based off of which companies pitch the best story. But a few days ago I was reading through Comcast’s 10-k and it hit me that I wasn’t really learning anything new there / my time was better spent listening to what they were saying at their most recent conferences. Maybe that’s a fringe example since I’ve spent a lot of time in both the cable and media industries recently, but the switch from a focus on 10-k reading to more industry / conference research is something I wanted to write about, both to explain why and see if anyone else has experienced something similar or has pushbacks on that process.

Let’s start with why I made the switch. As recently as a few years ago, I was much more of a deep value investor. To me, the most important thing that mattered was an extremely cheap price. My biggest focus was really on “net-net” companies (companies whose market caps were less than the value of their current assets less all liabilities). And finding net nets or super cheap companies is actually pretty mechanical- just start opening financials for a bunch of companies, make some quick calculations, and confirm there's nothing about the company that would make the calculation way off (i.e. a company looks like it's trading for 2x earnings, but a huge chunk of their earnings were a one-time gain). The most important thing here is to just turn over tons of rocks very quickly so you can find the really cheap ones.

However, the thing with net nets is that they are generally not great businesses. In fact, most of them are not even good or normal businesses. So you really need a combination of diversification (because a few will invariably take a negative turn) and good timing to some sort of event (because time is generally the enemy of these businesses, both in terms of the IRR for your investment and the likelihood the overall business is successful).

Maybe it's just because we're in the later stages of a historic bull market, but it increasingly seems that looking for net nets is picking through a tiny pool of the same 10-20 companies that have been net-nets for the past few years because of blindingly obvious issues. Things like failed drug companies with a pile of cash management seems intent on burning, dying retailers with huge off balance sheet liabilities that prevent a successful liquidation, or companies losing money so quickly that they won't be net-nets by the time next quarter's earnings are filed. So you're digging through a tiny pool of potential investments with obvious hair on them to execute an investment style that requires both decent diversification and good timing. Not exactly the formula for successful investing!

So, over time, I've shifted much more to a high quality investing style. I want to find good to great businesses that the market isn't pricing like good or great businesses. And finding those generally requires one of two situations:

1. Some type of existential panic that the market overestimates. The classic example here is Buffett / AmEx in the 60s. These are, unfortunately, few and far between, but the rewards can be substantial.
    a. Equifax (EFX) in the wake of their historic breach could be such an opportunity, but I don't have the subject expertise to call it one way or the other and, honestly, it doesn't look cheap enough for me to want to ramp up on it (even after the huge decline, it's trading for ~20x earnings, which is still pretty lofty!)
2. Some shift in business conditions that have dramatically changed a company's (or even an entire industry's!) structure / outlook but that the market hasn't picked up on yet.
    a. The classic example of this would be a truly transformational merger. To take this back to Charter, if you listened to them when they bought Time Warner and ran the math on just how large the synergy / cost cutting / growth opportunity was, you'd realize the merger would create massive value for shareholders and the market hadn't come close to adjusting for

that.

b. The other classic example is a shift in management that replaces a sloppy manager with a good one. I'm always surprised by how quickly a business can improve when a good manager replaces a poor one.

   i. Canadian Pacific is a classic example here. The company had long argued their margins were permanently disadvantaged versus peers, but a new and focused manager managed to bring the company's operating ratio down from ~90% in 2011 to the mid-60s by 2016. Yes, some of that was aided by a strong economy, but plenty of people thought that Canadian Pacific could never approach those margins.

   ii. A current example of this could be Pandora (P) on the heels of Sirius's investment and new manager could qualify as well. I'd never want to bet against the Liberty team (who control Sirius (disclosure: long through the Liberty Complex) and clearly wanted that deal), and Jana Partners clearly sees an opportunity, but given the industry structure (Apple Music, Spotify, Amazon Music on the competitive side; the giant music companies on the supply side) I think it's going to be a tough ride. I'm rooting for them though!

   iii. Stewart (STC, disclosure: long) could be a future example here. The same CEO / family has been running it for years and has frequently argued that the company can't get to peer margin levels for a variety of reasons. Maybe they're right, but I hope that at some point a new CEO gets a chance. I wouldn't be surprised if the results were very similar to Canadian Pacific.

c. On the full industry shift side, Buffett realizing consolidation and Asain imports had taken the railroads from awful businesses to strong ones in the mid-2000s is a great example.

   i. Where could we be seeing one today? I'm not sure. A contrarian view would be in the wireless market as we shift to 5G. If 5G is as good as some execs say/think/dream (VZ's CEO said 5g will result in 100 times more devices that can be connected to the network. 100 times the throughput. Overall capacity per spectrum will be 1000x"), I could certainly envision an environment where they take significant share from cable companies (5G would be a replacement for broadband, and cable companies would be seriously disadvantaged given they lack full national coverage and wireless's blanket coverage would fall outpace any home / wifi network cable could muster) and accrue significant profits (as they take share from cable companies, competition between wireless companies probably eases, perhaps aided by cutting the national players from 4 to 3 if TMUS / S happened). I'm not saying that scenario is likely (I'm long the cable companies so obviously I don't think it is), just using it as the first example I can think off as a potential present day industry shift.

    ii. It's easy to get hit wrongly calling industry shifts though. Think of how many people thought rental cars were undergoing a shift once they merged down to two/three players a few years ago.

  d. Sticking with full industry shifts, most cable channels (Viacom, etc) a few years ago would have actually qualified for this "unrecognized industry shift", but just on the short/sell side: the market was pricing them like the cable bundle would remain dominant forever and hadn't adjusted for how quickly cord cutting / Netflix would lead to a huge shift in the industry.

The issue is that catching either of those shifts requires a deep industry understanding and an eye on the future. And while 10-Ks can help with industry understanding, they're better for understanding past results and historical industry structure, not how an industry is changing in real time. The best tool for figuring that out is listening to industry experts discussing what they are seeing, and what better source than listening to the ultimate insiders (CEOs) discussing in real time what they are seeing (i.e. conference transcript)?

Don't believe me? Consider Warren Buffett's investment in airlines. What made Buffett change his mind about investing in airlines was a presentation that American's CEO gave in March 2016 where he urged investors to take a "leap of faith" that consolidation had ended the boom-and-bust cycle of the airlines of the past. I can (almost) guarantee no lawyer or accountant is going to allow anything close to that language to enter into a company's regulatory filings. I just flipped through American's 10-k, and I can guarantee you I didn't get any sense of an industry shift / see any discussion of one. Now, I did see that the company was more profitable than it had been, say, five years ago, but if I simply looked at American's history I would've probably assumed that the company was simply in a cyclical upswing, not undergoing a full secular shift (and personally, I'm not sure that this isn't cyclical versus secular. I'm just talking from Buffett's view). I doubt it would be possible to realize this was secular, not cyclical, simply through looking at company 10-Ks, and, even if you could, by the time the numbers really showed that the industry had shifted it would almost certainly be baked into the price.

Of course, this brings you to the obvious downside: CEOs / corporate executives are generally in their roles because they're really good at convincing people of things. If the only thing you listen to is what CEOs are saying at conferences, you'll quickly be taken in by hucksters who are always pitching "this time it's different."

I think there are two things that can really prevent against that type of salesmanship

1. Read / listen to transcripts over a long period of time. How does what the executive says compare to what actually happens? Is the CEO a perma-bull? Does he generally undersell how the company's doing? If a CEO says "the industry fundamentals seem to be improving" that quote means absolutely nothing on its own. If, however, you've read everything the CEO has said over the past three years and this is the first time the CEO has been bullish on his industry, that can tell you a lot.
    a. Let me give a somewhat topical example. I think a lot of microcap investors are getting excited about Noble Roman's (NROM) new Craft Pizza and Pub Initiative. That's completely understandable- the new units seem to be doing great and the returns seem awesome. I've got a disastrous history with the company / stock, so take this with a grain of salt but I would just caution current investors: compare what they are saying about their current growth plans to how they talked about their grocery take-n-bake plans in 2016 or their take-n-bake franchise growth plans back in 2013 / 2014. On its own, the new comments on Craft Pizza and Pub would be wildly bullish. When you compare it to how management has previously talked about growth initiatives, they probably deserve to be discounted a bit.
2. Use financials to check what a company is saying. If a CEO is up there saying "we are taking market share", then they should be growing faster than their peers. If he's up there saying consolidation has markedly changed the industry, then all of their peers should be seeing expanding profit margins, declining capital intensity, etc.
    a. I don't have a topical example off the top of my head, but you would be surprised by how often the financials are at a complete mismatch for what an executive team is saying (i.e. revenue is declining and margins shrinking while CEO saying they've never been stronger).

Anyway, I'm going wrap this post up with one more interesting thought: if there's a lot to learn from conferences and industry publications, you're almost certainly looking into an industry that has some form of competitive advantage / is a good business (or at least has the potential to be one). Consider the restaurant industry for a second: there's not much to be learned from a lot of their conferences. They'll probably talk about how food inflation, wage inflation, and customer traffic are trending within a quarter. Those are all things that are easily discovered in a company's financials, and while it's nice to hear how their cost inputs are trending, it’s pretty much going to be the same for every company. So, at its core, the restaurant is a commodity business and strategy between companies doesn’t matter much, which makes the conferences pretty boring. Compare that to something like social media, where every company has a different strategy and every industry conference can dive into different aspects of that strategy. So much of that can’t be covered / picked up in a company’s financials (though the results will, over time, show up in the financials). Or, to compare it to something closer to the restaurant company, compare how a restaurant company talks at conferences to how a restaurant franchiser (i.e. McDonalds) talks. The later normally focuses on all sorts of new things: competition for franchisees, the give and take between charging franchises different marketing / royalty fees, how new promotions are driving traffic, etc. Because the franchise business is much more brand focused, you see a lot more strategy discussion at their conferences versus pure cost input discussion.

My new general rule of thumb is if I’m learning tons of new things (even if they are small insights!) every time I listen to a management team or industry expert speak, chances are I’m looking at an industry with some competitive advantages and the potential to have some good businesses. If not, it’s probably a much more commodity type business.