AN ANALYSIS OF INVESTMENT STRATEGIES

By

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Abstract:

This thesis discusses two separate lectures conducted by investment professionals for the students of FIN 498H Applied Investment Management at the University of Arizona's Eller College of Management. Both lectures focused on stock-picking strategies, but offered different approaches to investing. As a University of Arizona alumnus and Financial Advisor for Merrill Lynch in Tucson, Ken Morris exposes common investment pitfalls and suggests criteria for a concentrated equity portfolio. His main suggestion is to maintain a long-term investment horizon and hold a concentrated basket of companies that feature a sustainable competitive advantage at a margin of safety. As a hedge fund manager, CFA, and MBA from the GSB, Peter Brimm reveals his exhaustive and meticulous investment research process that he uses to make large bets on only a few stocks.

I. *Introduction*

The general excitement and interest surrounding the world of investments can be attributed to its tendency to supply seemingly unlimited economic prosperity or ruin with cutthroat intensity. An investor’s participation in the market stacks their funds against the bets of thousands, if not millions of other market participants. In a realm of relentless pursuit of return on investment, an investor must engage the markets with a sophisticated strategy and goal, or meet his fate at the mercy of the invisible hand. The following analysis discusses guidelines and advice from two investment experts on how to develop effective approaches to equity investing.

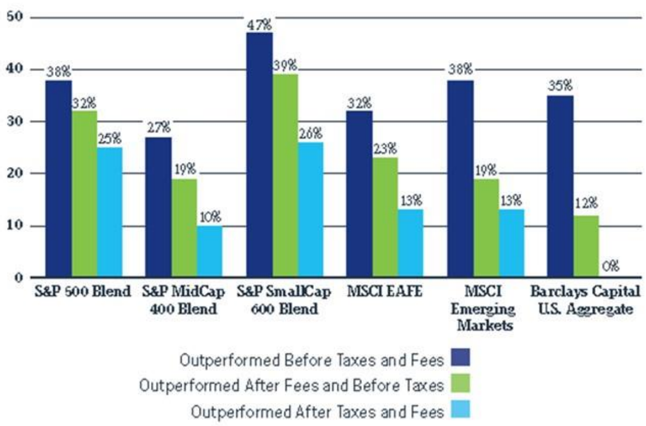
II. *Ken Morris, CFP, MBA*

Currently a Financial Advisor for Merrill Lynch in Tucson, Ken Morris graduated from the University of Arizona with a BSBA in Finance and Accounting, and subsequently earned his MBA from the University of Arizona. His professional experience ranges from auditing at Deloitte and Touche to acting as a managing member for Morris Asset Management. After years of exposure to the financial markets, Ken Morris advocates a balanced and disciplined investing approach driven by value. He believes that “beating the market”, or outperforming a benchmark index such as the S&P 500, a collection of the leading 500 US equities by market capitalization, is achievable on a reliable basis. However, he warns against some common approaches that are suspect to diminish the return potential of an investment portfolio. First, we will consider what approaches Ken Morris believes ultimately hurt portfolios. From there, we will have a basis for understanding what factors could contribute extra return to buoy your investments over their respective benchmarks.

*III.	Ken Morris On Detrimental Tendencies*

Ken Morris is not an advocate of active management, a method of investing that often involves high frequency of trading and a reliance on buying and selling at optimal prices over a short horizon. If done carefully, active management may generate excess returns, but this is not easily accomplished. Over a 10 year period ending December 2009, only 25% of active managers outperformed the S&P 500 Blend benchmark fund after taxes and fees. Only 10% outperformed the S&P Midcap Blend fund, a collection of leading U.S. equities with mid-range market capitalization. Additionally, no active manager outperformed the Barclays Capital U.S. Aggregate, a bond index composed of a large portion of U.S. investment grade bond securities.

Figure 1: Impact of taxes and fees on active manager performance
Percent of active managers who outperformed their respective benchmarks over 10-year period



Sources: Morningstar, BlackRock. 10-year period ending 12/09. Data is survivorship adjusted, and is based on the oldest share class of active open-end mutual funds to avoid double-counting of multiple share classes. Tax cost calculations are based on a 35% investor tax rate assumption for income and short-term capital gains and a 15% investor tax rate assumption for long-term capital gains. Actual tax costs depend on the investor's tax situation and may differ from those shown. Past performance does not guarantee future results.

How could a massive group of intelligent investors put up such a poor collective performance? Ken Morris says that common active-investing strategies such as market timing, high portfolio turnover, and too much consideration on gut instinct and analyst opinions often depress a portfolio's return performance.

According to a market timing study by the University of Utah and Duke's Fuqua School of Business, 75% of cash and equity weighting recommendations from 237 investment newsletters dating 1980 to 1992 would produce negative abnormal returns by underperforming their respective benchmarks. Ultimately, the study concluded that few are able to consistently time the market and some of the persistence of outperformance among active managers as a collective can be attributed to "survivorship bias". Survivorship bias refers to the statistical anomaly that skews return performance in the positive direction because reports do not consider funds that dissolve from year to year due to underperformance, thus overweighting funds with positive performance. What could be driving this collective underperformance?

Ken Morris believes that active managers are likely missing large upward movements by disengaging and re-engaging the market. From 1993 to 2012, the value of $1 invested in the S&P 500 would've grown to $4.85. Hypothetically, if an investment manager attempted to time the market and subsequently missed the best 12 months of S&P 500 performance from 1993 to 2012, his $1 would have only grown to $1.79. That's less than the value of $1 invested in risk-free Treasury Bills ($1.81). Expanding on this analysis, the value of $1 invested in the S&P 500 from 1926 to 2012 would be $3,533, while missing the best 40 months would land your $1 at $20.34 compared to $20.57 for Treasury Bills. According to this data, active managers must be precise in their timing and intuition of the markets in order to outperform an index that is guaranteed these gains. Active managers may argue that timing the market correctly and missing the worst months of S&P 500 performance would likely lead to gains superior to an index, but passive managers can soften the blow of harmful months by balancing their portfolio across a variety of asset classes and sectors without having to make significant changes to their portfolio weightings. Aside from performance relative to hypothetical benchmarks, market timing can also deflate portfolio performance due to tax implications. Frequent trading and realization of gains leads to frequent taxes and a smaller investable base. On the other hand, a "buy and hold" strategy allows investments to grow and compound before being taxed at the end of the investment horizon, leading to significant growth over a portfolio with similar investments and high turnover.

There are other methods of investing that Ken Morris warns against, such as buying a stock because you like its product. As most professional investment managers know, a good company or product does not imply a good underlying stock. Companies with a trendy product and/or a lack of diversification in their mix often lead to overvaluations and a stock price that is not indicative of their future cash flows. For example, Crocs, Inc.'s stock price peaked at just under $70 in 2007, only to crash to $3 a year later. While poor business management and lack of diversification may be blamed on executives, investors who purchased the product because of its popularity are ultimately responsible for the overvaluation, and subsequently learned that a good product does not always carry a healthy underlying stock. Similar to investing in companies with trendy products, investing based on what is trendy with analysts is not a way to outperform the market.

While analysts are typically intelligent and hard-working, their ratings are often biased. Ratings can be skewed according to the collective sentiment of the analyst sphere. By following the crowd, analysts create a safety net for their less accurate ratings. They cannot be fairly criticized if they were wrong and the consensus was wrong as well. On the other hand, an analyst could lose their job if they rate against the consensus but are ultimately wrong in their assessment. Additional upward bias in ratings is created when companies pay analysts to rate their securities. An analyst that positively rates a security is more likely to continue to be paid to rate the company than an analyst that does not rate them favorably and hypothetically contributes to the devaluation of the company.

Investing on gut instinct can hurt portfolios as well, leading to selling a position when the value is cheap relative to its historical and future value. Throughout the investment cycle, which is interconnected with the economic cycle of growth and recession, investors often sell their investments cheap after losses have incurred, and subsequently miss price rebounds that are encouraged by the nature of the business cycle years, months, or even weeks later. Overall, having faith in a diversified approach and not budging when results are discouraging is the most reliable approach to reaping the benefits of the financial markets.

IV. Ken Morris on Effective Strategies

Despite the numerous pitfalls already discussed, Ken Morris believes that there are appropriate ways to boost an investment portfolio in addition to adopting a diversified and passive approach. Ken Morris suggests picking stocks that have a *sustainable competitive advantage* at a *reasonable price*. Morris defines a sustainable competitive advantage as a "Wide-Moat". Companies with such features often have high return on equity, high return on invested capital, high return on assets, and/or a high profit margin compared to its industry. Companies with a "Wide-Moat" could have these features for numerous reasons, such as pricing power and high volume of sales, thus generating abnormal revenue relative to capital. Examples of competitive advantages include efficient scale as a result of few market players, low-cost production capability, intangible assets such as copyrights or licenses, and high customer switching costs. It is important to repeat that these features must be sustainable, meaning the competitive advantage can withstand pressure from those seeking to mimic the competitive advantage. The competitive advantage must survive overtime because the value of the cash flow from the stock is mainly derived from the later years. According to Morris, 75% of the intrinsic value of the stock market is from free cash flow earned past 10 years in the future. Only approximately half of the intrinsic value of the stock market is derived from the first 25 years. To help evaluate a stock under these circumstances, Morris recommends considering the value of the investment if the stock market were to shut down for 10 years. If this would be an uncomfortable position, then the investor is likely speculating rather than value-investing, as their horizon of analysis is presumably short-term. Morris also suggests avoiding tech stocks, as the technology landscape changes quickly and can render competitive advantages suddenly obsolete. When paired with a low stock price or valuation (reasonable price), a company with a "Wide-Moat" may be a suitable candidate for an equity portfolio.

Additionally, Morris recommends buying and holding a concentrated portfolio of stocks at a margin of safety. Margin of safety refers to the purchase of a stock with a calculated undervaluation of more than 10 percent. This is sound advice for value-investing because it ensures that minor miscalculations or differences between projected estimations of cash flows and the actual realized cash flows do not lead to the acquisition of an *over*-valued stock. The level of concentration within the portfolio can be left to the discretion of the investor, however portfolios with fewer stocks have a better chance of outperforming the market.

The table below displays the annual results of randomly assembled stock portfolios from a collection of 1,200 companies with measurable data over a 10 year period:

Stocks in Portfolio	Simulations Performed	Standard Deviation
250	3000	0.65%
100	3000	1.11%
50	3000	1.54%
15	3000	2.78%

Stocks in Portfolio	Best Performance	Worst Performance	Beat the Market
250	16.00%	11.40%	63
100	18.30%	10.00%	337
50	19.10%	8.60%	549
15	26.60%	6.70%	808

While the 250 stock portfolios experienced much less standard deviation than the 15 stock portfolio, the upside of the 15 stock portfolio topped the 250 stock portfolio by over 10%, while only experiencing a downside of less than 5%. According to Morris, this should be enough motivation for investors to construct a concentrated portfolio. When partnered with sound investing principles such as picking stocks at a margin of safety that will survive for 20 years and feature a sustainable competitive advantage, an investor has optimal chances for beating the market.

V. Peter Brimm, CFA, MBA, Hedge Fund Manager

As an MBA holder from the Stanford Graduate School of Business, Peter Brimm has developed his own theories for how to effectively generate excess returns. Brimm has investment experience at multiple hedge funds, including First Q Capital, a firm that he owned for nearly 6 years. While he may not argue with most of Ken Morris' suggestions, Brimm focuses on an even smaller investable basket. The small set of securities he handles allows him to develop an extremely in-depth understanding of companies, industries, geographies, and other relevant segments. As a cautionary note, Brimm advises all aspiring stock-pickers to reconsider their passion for financial analysis immediately. Brimm argues that picking only a few stocks is the best way to generate excess returns, but advises against this strategy for investors that do not have an intense passion for investment analysis. Investors who do not share this sentiment are likely to find themselves drowning in research without anything to show for it. The majority of the process he discusses involves the idea sourcing and screening stages of stock-picking. However, Brimm shares a few general lessons before disclosing this process.

VI. *Peter Brimm's General Guidelines*

Brimm's first tip is to constantly read investment related material. This ranges from books on investing styles, market history, company histories, industry publications, and news articles, to name a few. While a large majority of information may not provide valuable insight, "random tidbits" could lead to a powerful investment thesis. Additionally, Brimm emphasizes that investing is not for the feeble minded. He recommends that an investor should always be willing to revise his investment thesis or scrap it entirely. Accordingly, young stock-pickers should not rely on their initial performance results as an indication for their stock picking ability; it is highly likely that an element of luck is involved. Brimm also advises investors of all ages that they should not remain committed to a successful idea despite contradicting signals. Stubborn funds are often harmed by their inability to change their mindset.

A possible tool for idea generation and investment screening are 13-F's, quarterly SEC (Securities and Exchange Commission) filings that disclose the recent investment holdings of institutional investors with over $100 million in qualifying assets. Brimm refers to these filings as a "gold mine" for new ideas. However, discerning good ideas from bad ideas is another complicated issue.

The quest for a good investment idea often starts with developing an 'edge' in a particular area. In other words, investors should source ideas from industries that are familiar. Some time may pass before an aspiring investor finds their edge, but Brimm strongly believes that all investors eventually need an edge to survive in the market. It is also essential that investors constantly question their thesis during the research process. Buying or selling a security implies that the investor knows something that the market does not, which may be an arrogant gesture if not properly justified. Respect for competing investors on the other side of the investment is a necessity. Brimm cautions that "You better ask 'why' over 100 times in your research or you are wrong". An investor must assume they are missing something that the rest of the market has factored into the current price of the investment. This is not an easy policy to exercise, as an investor may ask himself this question hundreds of times and ultimately find himself "digging a dry well" if he follows Brimm's intensive research process.

VII. *Peter Brimm's Research Process*

The beginning of Brimm's stock research process involves a thorough understanding of the industry value chain. Otherwise known as Porter's Five Forces, understanding the industry value chain demands familiarity with the competitive landscape, customers and suppliers. Knowing the competitors, how they compete, and the threat of new entrants or products is essential to understanding not just the value chain, but the company as well. Knowing the power and flexibility of customers and suppliers is important as well. Companies flex their business models and operations to fit the needs of these players. Understanding this framework provides a foundation for the rest of the research process.

In addition to the value chain, industry and company histories provide relative information that can help an investor recognize where the company is currently positioned in industry trends, their performance relative to competitors, and how they have improved or deteriorated as companies. Being able to differentiate between expected trends and unexpected anomalies demands more insight into the actual state of the company and where it may be headed. A few examples include seasonality in revenues and margins, length of company lifetimes, trading multiples (price to earnings, price to sales), and growth rates across segments and competitors.

After gaining insight into the general landscape of the company and industry, it is time to dive into company specifics. This is where Brimm re-emphasizes the importance of reading, especially source documents. Brimm recommends beginning with the first two 10-K's (annual report to shareholders), the last 4 10-Q's (quarterly report to shareholders), and transcripts from management including the last 3-4 year-end earnings calls (management discussion of financial results). These reports assist in identifying the strengths and weaknesses of a company, as well as company outlook. However, investors must treat these documents with a grain of salt because they are often biased and tailored to please analysts and investors or at least soften the blow of a disappointing quarter. Brimm also recommends reading the company proxy. This is a less conventional tactic, but may be useful in determining management motives because it discloses how executives are compensated. After developing a strong familiarity with the company and industry, it should not be difficult for an investor to determine what drives the business fundamentals. This is another important step in the research process.

The factors that drive businesses vary across companies, but typical considerations include customer seasonality, location and concentration of stores, logistics, and government regulation. Comparing evolution of these factors over time with the movement of the stock price may reveal which of these factors have the greatest influence on the movement of the stock price. However, not all of these factors will have an observable effect and many are offset by other loftier factors. It can be difficult for some investors to grasp the notion that the set of factors that influence the business fundamentals will not be the same set of factors that drive the stock. However, realizing this distinction is a difficult but important objective. An investor may recognize a positive impending effect on business fundamentals but not be able to translate this insight into return because this effect did not transfer to a positive effect on price. Developing a model that forecasts financial statements and stock price given flexible scenarios is a productive way to better capture the influences of certain factors on stock price.

The mechanics and analysis of this process can be intimidating to even the most seasoned stock-picker. However, Brimm stresses the importance of always taking a step back from the details and asking the “Why?” question: Why this particular stock? Why not a fund? What do I know that the market doesn’t and why will this affect the price? If an investor has made an honest effort throughout the entire process and can confidently answer these questions, he may not be digging a dry well after all.

VIII. Closing Notes

It is important to keep in mind that Peter Brimm's investing strategy is more concentrated and likely more volatile than Ken Morris' approach. Therefore, a "Brimm investor" focuses much more heavily on individual security research and less on portfolio diversification. Each strategy has their merits. Brimm's strategy, if done correctly, can lead to the highest achievable returns for an individual investor but is much more demanding in the areas of business savviness, acceptance of volatile returns and commitment to a meticulous research process. Morris' approach of holding a concentrated portfolio of stocks with a wide-moat will likely be less volatile and produce modest excess returns, but does not demand the firm-specific risk and research dedication of its counterpart. Everyday investors are likely to resonate with Ken Morris' approach. For those seeking maximum economic prosperity, Peter Brimm provides a framework for an arduous stock-picking career.