# THE FALCON METHOD NEWSLETTER

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# The Forgotten Trinity

*Despite the flawless fundamental performance of the underlying business, overpaying for the stock turned it into a bad investment. This is the exact filter that kills most of the investment opportunities in today's market.*

Here's a thought-provoking opinion as a starter: **one good idea a year can make you an exceptional investor**. This was the expressed belief of our tutors at Columbia Business School's value investing course that I have completed recently. On the one hand, I couldn't agree more, on the other hand, I realize that most people do want more. Newsletter subscribers, in general, crave a never-ending stream of investment ideas since they think that this is what they signed up for. However, if demand can successfully force the number of published ideas to go up, then the quality of those ideas and the resulting investment performance will suffer.

Where do you think the market is today? Indices are still near all-time highs. Valuation multiples are near all-time highs even after the beneficial effects of the tax reform and the recent correction. The value-growth disparity is near all-time highs, meaning that growth stocks have comfortably outperformed value stocks lately. The yield curve is close to inverting. We are late into an economic cycle. Interest rates are increasing, and the Fed is trimming its balance sheet. Was this short summary convincing enough that investors should be cautious and **attractive value opportunities are incredibly hard to find today**?

If not, then let's turn our attention to how the total return of an investment is made up. We'll essentially revisit Chapter 7 of [The FALCON Method book] since the trinity of total return components is unchanged although some experts seem to be oblivious of this when generating ideas for their clients. **Before you buy a stock you already know that your return will come from two sources**, the first being the dividends that you pocket throughout the holding period and the second being the price increase (or decrease) of the stock. This latter price component is affected by two factors: the growth of the underlying business and changes in the valuation multiple that the market assigns to that company. So the key components are dividends, growth, and changes of the valuation multiple. Ask any sensible investor and no one will dispute this. As simple as it sounds, ignoring even one part of the trinity can cause serious calamity.

Although the valuation part of the equation deserves the most attention at this point, let me briefly touch on the other two as well. My experience says that **novice investors tend to overemphasize the dividend component and base their buying decisions solely on the entry yield**. This is a disastrous approach since most of the high-yielders in today's overheated market are companies with broken business models thus the two remaining components of the total return will likely act as serious headwind. This is not to say that "high-yield investing" is not a powerful slogan these days but as soon as you take a closer look at the growth and valuation characteristics of the investments that those advertisements are trying to sell you, your appetite will likely be reduced.

Focusing on growth alone is not any better either. Most "growth investors" commit the cardinal sin of being too lenient on valuation and thus overpay. Most of the time, the predicted high growth is already baked into the price and if it fails to materialize then the stock gets slaughtered. Not a good position to be in. Don't get me wrong, every thoughtful investor loves growth! The point is that **value investors want to get the growth for free or at a deeply discounted price**. This is what happened when Apple was hovering below $100 and I was accumulating the stock. The market was virtually pricing a no-growth scenario with a quality company that had more than promising growth prospects. In fact, this is the approach that the Columbia course also advocated: buy a top-quality company when it is priced attractively even in a scenario where it would simply sustain its current level of earnings and not grow at all. In such a case, you are getting all the growth for free. This is certainly not what most people do when investing in today's hot tech stocks.

The last component is the valuation multiple. Ignore this and you'll find plenty of opportunities in any kind of market. This one is the culprit for why stocks of the best quality are not investable today. Simply put, **the valuation multiples of the crème de la crème are at historically inflated levels thus making the risk of multiple compression extremely high**. A simplified example can highlight how serious a headwind this can be. Let's say that Super Company's shares are trading at $150 while the earnings per share is $5. This gives us a valuation multiple of 30, meaning that investors are paying 30-times earnings for the shares in the current market euphoria. The company has a wide moat and is growing earnings at an annual pace of 10%. Five years from now the earnings per share is $8. Impressive! The company could hardly have done more for its investors, I hope you agree. Yet if the market came to its senses in the meantime and is assigning a more reasonable valuation multiple of 15 to the same stock then the price will be $120 by the end of the five-year period. **Despite the flawless fundamental performance of the underlying business, overpaying for the stock turned it into a bad investment. This is the exact filter that kills most of the investment opportunities in today's market.** I was simply amazed when a newly launched investment newsletter claimed that it had found 19 stocks to buy in its first two months. Coming up with such a number of investable quality stocks is impossible today as long as one keeps an eye on all the three components of the total return equation. Ignore the multiple at your own peril!

I want to make it perfectly clear that examining various valuation multiples in historical comparison is not the same as determining the intrinsic value of a company. **Multiples are indicators of sentiment and not tools of valuation!** This is something that analysts should keep in mind as well. Having said that I believe that buying top quality companies when the sentiment is utterly negative is more than enough to generate good returns. In fact, Columbia's course also discouraged making complex intrinsic value calculations based on discounted cash flow (DCF) analysis. The main reason is that **the DCF method is way too sensitive to the inputs (that are all based on your assumptions), and as a result, the model is like the Hubble telescope: you turn it by a fraction of an inch and you are in a different galaxy**. Such a tool may be useful for someone who wants to showcase his expertise but not for real investors.

To add a layer of complexity, I am ready to admit that the three components of the total return are intertwined. Imagine that Company-A has great reinvestment opportunities that could produce considerably higher rates of return than the firm's cost of capital. Do you think that such a company should pay more dividend or take advantage of those reinvestment opportunities to maximize shareholder wealth? (The second, of course.) Do you think that a business with such reinvestment opportunities should be valued at a higher multiple than one that is lacking such opportunities? (Of course!) The dividend and valuation characteristics can change in tandem with the changes of the incremental return on invested capital that the company can achieve. This topic alone could fill a book, but I wanted to throw this in for those of you who love to dig deeper.

The main point is that an investor must be aware of the three components of the total return equation and must never lose sight of any of them. In today's market, the valuation multiple renders almost all quality stocks uninvestable. In fact, **one of our tutors at Columbia has the job of analyzing private companies all day long and she said that even the private market was so overvalued that reasonable investment opportunities had almost dried up**. In such an environment it is not too surprising that I cannot identify 10 stocks to buy today, this is why you should always look at the Top Picks section on the Summary page (instead of the Top 10 table) as I emphasized in the June 2018 issue. Patience is needed and you absolutely must become comfortable with getting rich slowly.

Was this radically honest? Author and WSJ columnist Jason Zweig has a three-part rule that he learned from his father. It says that there are three ways to make a living: 1) Lie to people who want to be lied to, and you'll get rich. 2) Tell the truth to those who want the truth, and you'll make a living. 3) Tell the truth to those who want to be lied to, and you'll go broke. For me, telling the truth is the only option and time will tell whether you belong to the group that wants the truth and thus will stick to the plan in the long run. Let's see what the FALCON spots this time!