THE FALCON METHOD NEWSLETTER

THE FALCON METHOD

The Best of Both Worlds

"The good thing about high-quality stocks is that you can pay up for them (never overpay), and still do well till the underlying businesses remain good." (Vishal Khandelwal)

The results are in. Half a thousand poll responses and dozens of emails reveal that 13% of the FALCON Method subscribers would like to stick with the classic mean reversion type of 'Fallen Angel' stock picks, 58% would prefer the 'EVA Monster' category for its long-term compounding power, and the remaining 29% intends to follow the top pick recommendations regardless of which direction we take. As I emphasized in the header of the one-question survey, there was no right or wrong answer since both investment approaches were reasonable and proven, so this quick poll was all about uncovering your preferences. That said, those of you who decided to share their opinion via email mostly asked **why we had to pick one category over the other instead of investing in the best opportunities of both worlds**. This made me think long and hard because identifying the best reinvestment moats (compounders) and the most promising mean reversion plays requires very different processes. Can one integrate these two approaches so that we could really have the best of both worlds in the FALCON Method newsletter?

To answer this question, let's start off with the fact that we do have an undisputed unifying platform since the three components of the total return formula remain the same regardless of the investment strategy we pick; it's just our focus that may change. (As a reminder: we have the dividend, the growth of the underlying business, and the expansion or compression of the valuation multiple that affect our returns. More on this in the November 2018 issue.) **With reinvestment moats (EVA Monsters), the key underlying factor of performance is the value-creating growth that stems from a company's ability to reinvest most of its earnings with high returns for several years to come.** If you identify such an investment target, the valuation multiple you pay to get on board only plays a minor role in your future total return as long as you were right about the business.

For the sake of simplicity, imagine a company with a ROE (return on equity) of 20%, the stock of which trades at four times book value. Assume that this firm can maintain its 20% ROE for 40 years while reinvesting all its earnings. Bear with me; I'm not saying that I'm capable of forecasting ROEs on a 40-year horizon or that this would be necessary for investment success, yet this example is here to convey a vital message about the valuation of EVA Monsters. If you invest $1,000 in the company, you are essentially buying a $250 equity stake (the price divided by the price-to-book ratio). Your $250 equity stake will produce earnings of $50 (with that 20% ROE) in the very first year, and this $50 all gets reinvested for you at a price-to-book ratio of precisely one. This is the key! The longer the company can continue this compounding magic, the more equity stake you will have in it, and you only had to pay up for your initial purchase in the form of a price-to-book ratio of four. **At the end of the 40th year, you would have a $367,443 equity stake, 99.93% of which you got at the incredible price-to-book multiple of one.** Even if disaster strikes and the valuation multiple collapses to two by the end of the 40th year when you have to exit this investment, your annualized return would still be 17.9%. With reinvestment moats of this kind, the valuation we pay upfront is of secondary importance, but this still doesn't mean that I'm willing to overpay for our EVA Monster targets, as you'll see.

The best we can do about EVA Monsters is to focus on their quality and valuation parameters in a market-relative sense. By this, I mean that we want to uncover companies that have superior return on capital and margin characteristics and also show convincing signs of growth on both the top and bottom lines (sales and EVA). Once we have a shortlist of these Monster candidates, we want to take a closer look at the ones that are available at a more favorable valuation than the market's current valuation level (as measured by the free cash flow yield of the S&P 500). Historical valuation multiples and 5-year total return forecasts are meaningless with these targets, as the previous little example demonstrated.

Please, don't get me wrong: we are not trying to predict which firms will become winners in their markets! The data we are focusing on clearly reveals that **these companies have already won, and all we have to do is wait for Mr. Market to quote us decent odds on them**. (This is still a waiting game, and to answer some of your emails: I haven't lost my patience; this is not the reason why I'm turning toward quality compounders.) Since we know exactly why we invest in these names, it's not too hard to keep an eye on the key parameters: the changes in invested capital and the level of ROIC that may reveal the returns on the incremental investment and thus the changes in the moat characteristics of the business. The longer a company can reinvest at a rate above its cost of capital, the better the tax-efficient compounding effect. These positions need monitoring just like the 'classic' mean reversion plays, and we will be wrong on some of these picks as well, but the risk of permanent capital loss doesn't seem higher than with the 'Fallen Angels.' (At least as long as we are not overpaying blatantly, which I assure you I am genetically unable to do.) To address a misunderstanding: **the FALCON Method does require the presence of the reliable dividend component with the EVA Monsters as well**, so stocks that pay no dividends but otherwise exhibit reinvestment moat characteristics could only make it into our Outlaw Portfolio. That said, these picks may populate 'The FALCON Method Global EVA Monsters' newsletter at some point, but we are nowhere near launching such a service; I was just thinking out loud.

So the first step of our stock selection process is to determine which companies have the quality and growth attributes of EVA Monsters, and we should rank these targets on these metrics while only using the valuation dimension as a threshold criterion. **We want to see those names ranked highest that are head and shoulders above the S&P 500 average when it comes to profitability and growth yet command lower valuation than the market average.** This is a good starting point for a deep qualitative analysis. Companies that fail to make the 'Monster' grade of quality and growth but still have positive EVA Momentum and Margin (proving that they are not destroying shareholder value) are to face our strict filter on historical valuation. With this category, examining valuation in a historical comparison is absolutely essential since we are playing for mid-term mean reversion. While we have no absolute dividend yield threshold for EVA Monsters (the more they can reinvest at high rates, the better), with Fallen Angels, the reliable dividend is an important component of our total return expectation together with the expected expansion of the valuation multiple (the sooner, the better). We employ a valuation-focused ranking with Fallen Angel candidates with certain quality elements included.

As you see, we have two parallel processes, so handpicking the newsletter's Top 10 becomes somewhat subjective. That said, **in times of panic when exceptional companies can be bought at fair or better valuation, the newsletter will hopefully be filled with EVA Monster targets** as I'll be buying those names hand over fist, while in times of market euphoria, we won't omit the most promising mean reversion picks. When investing, you should always ask the question, 'What can go wrong?' Knowing why you bought a stock in the first place (whether for its profitable growth or depressed valuation) gives you a wonderful opportunity to identify the key factors to monitor and come up with a pre-mortem detailing the possible paths to the future in which you don't reach your goals. A pre-mortem essentially forces you to build out that side of the probability tree where things don't work out.

After completing Columbia Business School's [Advanced Value Investing course] in February, I feel that the separation of the EVA Monster and Fallen Angel categories was the missing piece in my investment approach. (Not that they taught this, but I had time to think while listening to the professor.) This distinction also makes selling decisions more straightforward: While we should keep our Fallen Angel positions on a relatively short leash and sell when they approach fair value, we must recognize that EVA Monsters need that kind of extendable, longer leash since the valuation multiple is not the major part of our total return as long as the reinvestment moat characteristics remain intact. As Seneca said, "Time discovers the truth." **My long-term bet is on the EVA Monster category, but I will not shy away if Mr. Market tosses us some outstanding Fallen Angel candidates in the meantime.** Now let's see what the FALCON spots this time!

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