LESSONS FROM THE TRENCHES:

VALUE INVESTING, ENTREPRENEURSHIP & LIFE

HOW TO ACHIEVE SUPERIOR PERFORMANCE

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WHITNEY TILSON'S KASE LEARNING BOOTCAMP

DEVELOPING A STRATEGY

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THE FIRST STEP TOWARD BECOMING A SUCCESSFUL INVESTOR IS DEVELOPING A SOUND STRATEGY

- This is critical to both investment success *and* marketing
- To develop a sound strategy, you have to do a careful, honest self-assessment, asking key questions:
  - What am I interested in and what do I enjoy?
  - What am I good at?
  - What's my edge? (It's hard to develop one)
- A sound strategy addresses:
  - What countries, industries and market caps will I focus on?
  - Any short selling? If so, how much and what strategies?
  - How much overall exposure in the portfolio and how concentrated will it be?
  - How much trading/average holding period?
  - Will I invest only in equities or across the capital structure?

GOOD STOCK PICKING

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THREE WAYS TO BEAT THE MARKET

1. Good stock picking;
2. Good market timing; and/or
3. Leverage

I mostly stink at market timing (though I've had reasonable success identifying – often too early – obviously bubbles like the internet/tech stock bubble in 1999 and the housing bubble in 2007), and leverage will eventually kill you, so I focus on good stock picking.

STOCK PRICES REFLECT EXPECTATIONS

- Nearly every company's stock price reflects the consensus expectations that investors have about that company's future
  - This is usually fairly easy to determine by reading a few analyst reports
- Whether a stock goes up or down over time is largely determined by whether a company's performance exceeds or underperforms investors' expectations
- Therefore, investment success is rooted in accurately betting against the "herd"
  - Sometimes this involves identifying companies encountering difficulties that investors think are secular, but prove to be fixable (e.g., McDonalds, Best Buy, Restoration Hardware)
  - Other times, it's great companies that can maintain high rates of growth for longer than the market anticipates (e.g., Amazon, Google, Facebook)

VARIANT PERCEPTION

- To beat the market, all you have to do is have a variant perception…and be right!
- The former is easy; the latter is hard
  - "The hardest thing over the years has been having the courage to go against the dominant wisdom of the time, to have a view that is at variance with the present consensus and bet that view. The hard part is that an investor must measure himself not by his own perceptions of his performance but by the objective measure of the market. The market has its own reality. In an immediate, emotional sense, the market is always right. So if you take a variant point of view, you will always be bombarded for some period of time by the conventional wisdom as expressed by the market." – Michael Steinhardt
  - "It's much warmer inside the herd." – Jean-Marie Eveillard

> "If you just do what other people do, you will get the results other people get."
>
> – BILL MILLER

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THE THREE VARIABLES THAT DETERMINE A STOCK'S PRICE

- Most stocks' prices are a function of three factors:
  1. Revenue x
  2. Profit margin (= earnings) x
  3. The multiple investors are willing to pay for those earnings
- This seems very obvious, but it's helpful to think about this simple math when considering buying a stock (I'm excluding changes in share count)
- What do you expect will happen to each of these variables that will result in a higher stock price?
- Examples:
  – I think Google's revenue will grow 20% compounded for the next three years and think the margins and multiple will be steady, in which case I'll make 20% annually owning it
  – I think Facebook will grow revenue 30% annually for the next three years, but margins will contract somewhat and the multiple will be steady, also resulting in 20% annual returns
  – What's your math for Apple? Coca Cola?

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A THREE-STEP PROCESS FOR EVALUATING STOCKS

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THREE STEPS TO EVALUATING STOCKS

CIRCLE OF COMPETENCE

Step 1: Circle of competence

- Do we understand this company and its industry deeply?
- Can we make reasonable projections about the company's future?

Keep it simple. Good investment ideas can usually be explained in 30 seconds.

THREE STEPS TO EVALUATING STOCKS

COMPANY AND INDUSTRY EVALUATION

Step 2: Company and industry evaluation

- Often involves company visit, management and customer interviews.
- Is this a good business?
  - Does it have sustainable competitive advantages?
  - High returns on capital?
  - Solid, steady growth?
  - Healthy balance sheet?
  - Strong free cash flow?
- Is this a good industry?
  - Are the trends favorable?
  - What are the competitive dynamics?
- Look for an informational edge, often via proprietary sources or scuttlebutt research

THREE STEPS TO EVALUATING STOCKS

EVALUATION OF MANAGEMENT

Step 3: Evaluation of management

- Are they good operators?
- Are they good capital allocators?
- Are they trustworthy and shareholder friendly?

THE FINAL CRITICAL STEP: VALUATION

- Is the stock really, really cheap?
- Are you “trembling with greed”?
- Is there a *huge* margin of safety?

FOCUS INVESTING

- When you get an easy pitch, swing hard
  - Owning two stocks eliminates 46% of non-market risk of just owning one stock
  - Four stocks eliminates 72% of the risk
  - Eight stocks eliminates 81% of the risk
  - 16 stocks eliminates 93% of the risk
  - 32 stocks eliminates 96% of the risk
  - 500 stocks eliminates 99% of the risk

- Buffett's 20-punches analogy
- Sizing shorts and options

THOUGHTS ON VALUATION (1)

Discounted Cash Flow

- Present value of a 10-year Treasury note
- Same analysis for a stock or bond
- Focus 90% of your attention here

Public Company Comps

- Make sure comps are valid
- Make sure entire sector isn’t misvalued

Acquisition Comps

- What multiples are acquirers (other companies or LBO firms) paying for similar companies?
- Strategic vs. financial buyers

THOUGHTS ON VALUATION (2)

Historical Comps

- What multiples has this company traded at in the past?
- Has the business changed?
- Careful to exclude bubble periods

Sum of the Parts

- Often useful to break business down into its parts and value each part separately

Rules of Thumb

- Pay no more than 10x trailing earnings (normalized) for a fair business and no more than 20x trailing earnings for even the greatest business
- Paychex, Google, eBay

GAINING AN EDGE

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GAINING AN EDGE (1)

THERE ARE MANY WAYS IN WHICH A STOCK PICKER MIGHT TRY TO GAIN AN EDGE TO BEAT THE MARKET:

1. **Size**
   - Small funds can invest in the nooks and crannies of the market, in which there are more inefficiencies
   - Example: SPAC warrants
2. **Time arbitrage**
   - "Time arbitrage just means exploiting the fact that most investors – institutional, individual, mutual funds or hedge funds – tend to have very short-term time horizons, have rapid turnover or are trying to exploit very short-term anomalies in the market. So the market looks extremely efficient in the short run. In an environment with massive short-term data overload and with people concerned about minute-to-minute performance, the inefficiencies are likely to be looking out beyond, say, 12 months." – Bill Miller
3. **Concentration**
   - Invest in fewer, highest-conviction ideas – which works great when you're right, but can kill you when you're wrong
   - Example: Loading up on Berkshire at the right times

GAINING AN EDGE (2)

4. **Analytical**
   - Take the same information as everyone else and analyze it better; just be smarter
5. **Informational**
   - Gather better information (legally of course!) to inform better decisions
   - Examples: shorting the housing crisis; McDonald's; and CKE Restaurants
6. **Experience**
   - Investing is an experienced-based business, so those with more (relevant) experience can make better decisions
7. **Emotional**
   - "Investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ…Once you have ordinary intelligence, what you need is the temperament to control the urges that get other people into trouble in investing." -- Warren Buffett
8. **Relationships**
   - Building a network of other smart investors to share ideas and information
     - Example: MBIA
   - Getting to know certain CEOs and investing behind them
     - Example: HHC

TRAITS OF SUCCESSFUL MONEY MANAGERS

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TRAITS OF SUCCESSFUL MONEY MANAGERS

THE RIGHT APPROACH (1)

The Right Approach

1) Think about investing as the purchasing of companies, rather than the trading of stocks.
2) Ignore the market, other than to take advantage of its occasional mistakes.
   - "Basically, price fluctuations have only one significant meaning for the true investor. They provide him an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times, he will do better if he forgets about the stock market." – Ben Graham
3) Only buy a stock when it is on sale.
   - "To distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY." – Ben Graham
4) Focus first on avoiding losses, and only then think about potential gains.
   - "We look for businesses that in general aren't going to be susceptible to very much change. It means we miss a lot of very big winners but it also means we have very few big losers.... We're perfectly willing to trade away a big payoff for a certain payoff." – Warren Buffett

TRAITS OF SUCCESSFUL MONEY MANAGERS

THE RIGHT APPROACH (2)

The Right Approach

5) Invest only when the odds are highly favorable -- and then invest heavily.
6) Do not focus on predicting macroeconomic factors.
   - "I spend about 15 minutes a year on economic analysis. The way you lose money in the stock market is to start off with an economic picture. I also spend 15 minutes a year on where the stock market is going." – Peter Lynch
7) Be flexible! It makes little sense to limit investments to a particular industry or type of stock (large-cap growth, mid-cap value, etc.).
8) Shun consensus decision-making.
   - "My idea of a group decision is looking in a mirror." – Buffett

TRAITS OF SUCCESSFUL MONEY MANAGERS

THE RIGHT PERSON (1)

The Right Person

Most successful investors have the following characteristics:

1) They are businesspeople, and understand how industries work and companies compete.
   - "I am a better investor because I am a businessman, and a better businessman because I am an investor." – Buffett
2) They have a lot of intellectual horsepower.
   - However, "investing is not a game where the guy with the 160 IQ beats the guy with the 130 IQ" – Buffett
3) They are good with numbers -- though advanced math is irrelevant -- and are able to seize on the most important nuggets of information in a sea of data.
4) They are simultaneously confident and humble.
   - The former comes easily to most people in the business; it's the latter that presents the problem…
   - Buffett is a great role model

TRAITS OF SUCCESSFUL MONEY MANAGERS

THE RIGHT PERSON (2)

The Right Person

5) They are independent, and neither take comfort in standing with the crowd nor derive pride from standing alone.
6) They are patient.
   - "Long-term greedy" – Buffett
   - "If you find shares that are low in price, they don't suddenly go up. Our average holding period is five years." – John Templeton
7) They make decisions based on analysis, not emotion.
8) They love what they do.
   - "I'm the luckiest guy in the world in terms of what I do for a living" and "I wouldn't trade my job for any job" and "I feel like tap dancing all the time." – Buffett

OVERVIEW OF VALUE INVESTING

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WHAT IS VALUE INVESTING?

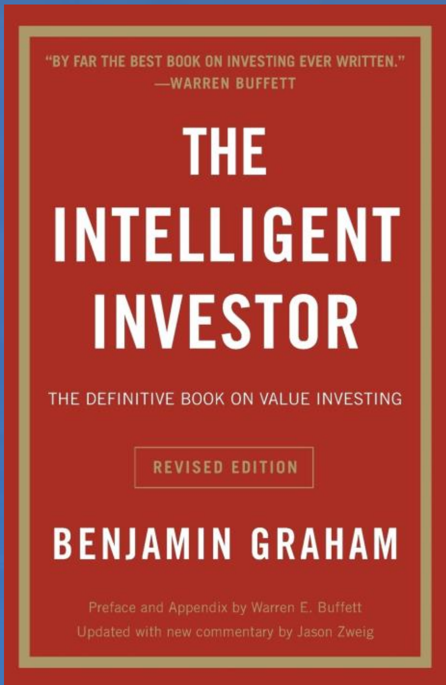
- Attempting to buy a stock (or other financial asset) for less than it's worth
- Contrast with greater-fool investing
- False distinction between growth vs. value investing
- Does *not* mean buying lousy businesses at low valuation multiples

> "All intelligent investing is value investing."
>
> – CHARLIE MUNGER

INTRINSIC VALUE

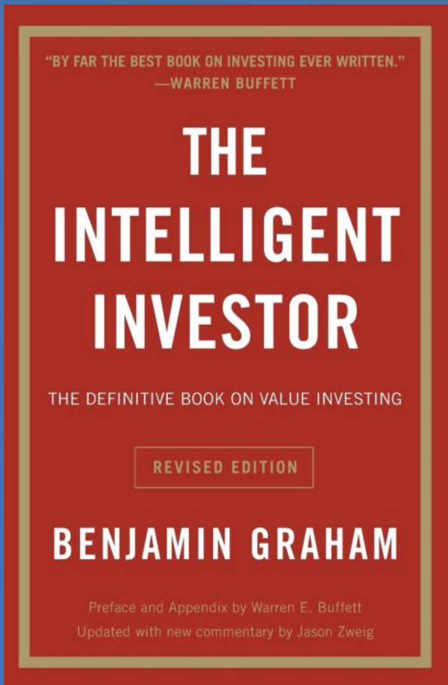
- The true value of a company or an asset based on all aspects of the business, both tangible and intangible
- It is most commonly estimated by projecting the future cash flows and then discounting them back to the present
- It is a range, not a precise number
- Intrinsic value is *not* the same as the current market value
- Value investors try to identify rare situations when there is a huge gap between intrinsic value and market value

MARGIN OF SAFETY



- Chapter 20 of The Intelligent Investor
- " The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price."
- The margin of safety "is available for absorbing the effect of miscalculations or worse than average luck."

LET THE MARKET BE YOUR SERVANT, NOT YOUR GUIDE



- Chapter 8 of The Intelligent Investor
- "The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored."
- The parable of Mr. Market

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