

The business of interpreting dreams

Measuring the company

Very few investors would view it as such, but investing is really the business of interpreting dreams. It doesn't matter what kind of investor you are, the business of interpretation permeates through every assumption, accounting and financial number you include in your analysis.

The business of interpreting dreams begins by choosing which company's dream you would like to listen to. In the vast universe of companies, which companies do you pick? Unless you are a deep value investor, perhaps the logical step is to first eliminate the weakest companies through screening.

Particular metrics such as the PE ratio and cash flow are popular filters in many screens. Ranking and putting a number value to a qualitative attribute is also very much utilised. Screening for the right companies is probably the most important step for investors.

To do this, just like carpenters, investors will need their own set of tools and materials. Some use basic tools, like Excel and Google Finance. Some have awesome spreadsheets that filter various metrics at a click of a button, built with lines and lines of code behind it. Price momentum is widely used in the current environment. There are also other types of metrics and signals that by themselves are trade secrets.

In the long run, you need to trust and hone your own tools. At the same time, you must be aware of the measuring tools that other participants use in the market. This is because other investors flow would drive the returns in the short run. It would be advantageous if you can pinpoint which dominant metric is driving the price of a particular company.

Carpenters will need wood to work on. The higher the grade of the wood that is being used, the better the woodwork will be. So it is with investors and data. The greater the quality and the more comprehensive the data, the better the analysis will be. Never underestimate the need for quality data in your analysis. It is very encouraging that more and more small investors have access to better data by subscribing to certain providers.

One always needs to return to every holding in the portfolio and check whether the premise, measurements and data still hold up. Data needs to be continuously refreshed. So do your measurements, they too need to be updated.

There will be many instances, especially when you are dealing with small companies, where history is sparse and data is not available. This is akin to entering a dark basement without torchlight and trying to ascertain what the growling animal is by touch and sound. Rather than

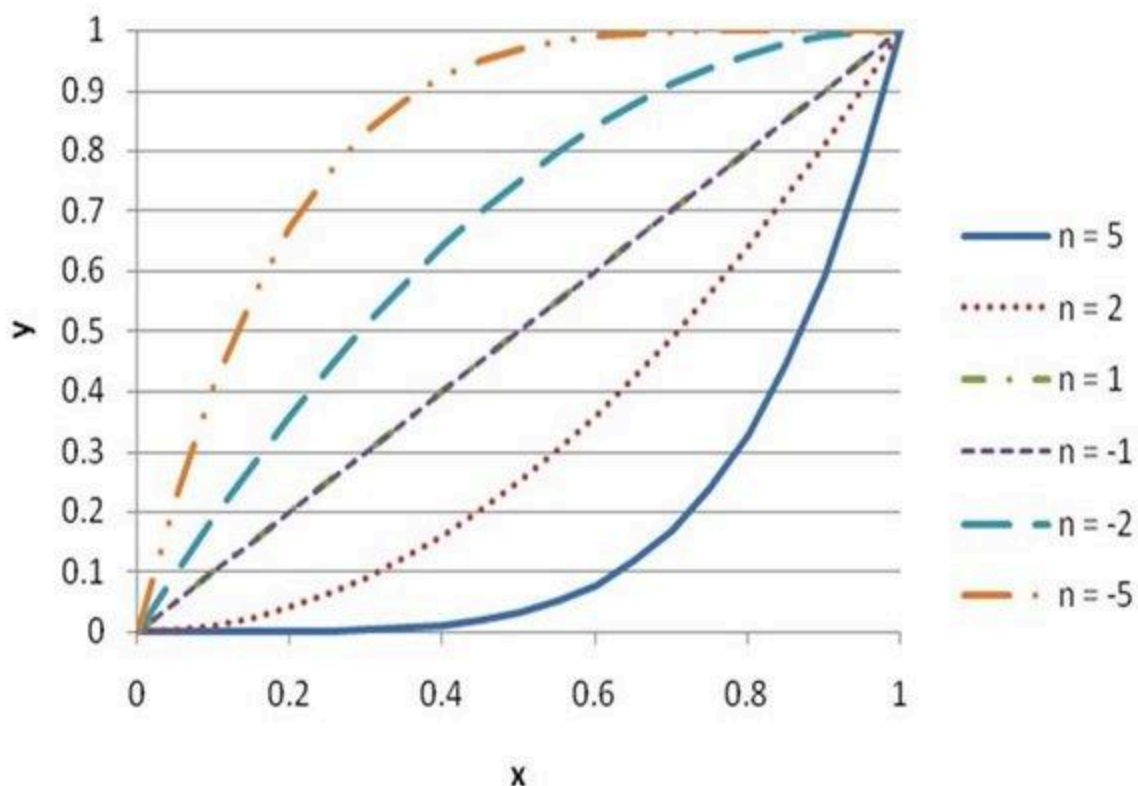
despair, this uncertainty could actually be used as a leverage, but a certain bravado is required. After all, the animal *could* be a tiger that would eat you up.

Alternatively, too much noise in your data could also create fog. Driving through this 'fogginess', I assume the advice would be to drive slowly, switch on your headlights and beware of random deers crossing the road.

Measuring the dream

Once a particular company has caught your interest, it will be time to measure its dreams. The time frame to achieve this dream is perhaps the most important consideration. After all, investment is all about pinning down the correct discount value, and without a time frame, this is not calculable.

A shorter time frame would be easier and more accurate to quantify, but a correct long term outlook would be so, so much more profitable.



Above is a non-descript plot of x against y for various n. All lines begin at 0 and ends at the same point. However, the paths each line takes to reach (1,1) are different. It is important to note that many similar companies take different paths to reach the same goal.

It is also important to note at what stage of the goal the company is being measured at. At $x=0.5$, some lines would give a greater y . Some companies would give greater returns in the medium term but the rate of increase of returns would taper with time. Some companies would seem to be laggards but all of a sudden experience exponential returns. In the long term, these similar companies end up in the same place.

Achieving dreams is a process and therefore, it is important to know at what stage the company is at in achieving this dream when you begin to measure.

A car needs fuel to get from A to Z. An athlete needs training and proper nutrition to win the Olympics. A company needs adequate capital, intellectual property, technology, skills and know-how to reach its goal. However, unlike the fuel in a car, or the amount of training or food for an athlete, it is hard to gauge just how much of the stated resources a company needs.



Vitalstatistix on a shield

So who gets a say to just how much? Who conducts forecasts of these variables? These agents may be influential in forming market's opinion of the company, and therefore influencing the amount of capital received by the company. Especially in the case of IPOs where public price discovery is occurring for the very first time, influential opinion makers can hold huge sway.

In a catch-22 of measuring dream and allocating capital, the amount of capital raised by the company can ultimately be the deciding factor of whether the company can dream small or dream big.

Sometimes, the dream may be suitably sized for the company's capability, but the timing is such that the business environment is not very conducive to the success of the dream. This too, needs to be taken into account.

Despite all the numbers, the judgement of whether the company is over reaching is largely subjective. There is nothing wrong with that, but it is something that investors must be aware of, and not delude themselves. Nothing is 100% certain. Or even 30%. Such is the business of investing.

Pitfalls

The biggest sin is probably overconfidence in your chosen company. Thinking that the company could do no wrong or no harm could befall on it, distorts your perception of risk involving the company or its dreams. We have all seen many times how investors' exuberance creates a level of confidence that is not determined by facts, but rather by sentiment.

A less obvious sin is in underestimating a company. Sometimes, biggest returns could be achieved by the most unglamorous, boring of all companies and sectors. Or in underestimating a little Chinook salmon to be able to swim against the currents up to the riverbed and betting only on the larger salmon to be able to make it.

What about when you *do* have all the facts laid out but fail to comprehend the significance or potential of said facts? This is where broad based knowledge including business and technological awareness will come in handy. In other words it pays to read a lot and educate yourself.

All companies and all dreams have exposures to uncontrolled factors. There are also exposures to factors that you would not naturally think of in the first instance. Black swan is a term that investors should be familiar with and Nassim Taleb has books on the subject. Globalisation means that if you invest in a construction company active in Australia, you have to think of the macro environment in Australia, and if a technology company selling mainly to China, the country you should be concerned about is China, and so forth.

Share pricing myopia stems from a mixture of too much caution and too little research. The more complex the situation, the more non-familiar the investor is with the sector, the greater the tendencies for pricing myopia. Then there is the obsessing over non-consequential aspects of the dream. This is akin to determining how beautiful the woman is by measuring a temporary pimple and ignoring the glint in her eyes.

Perhaps the most important edge an investor can get is to learn to tell the difference between perceived risk and true risk. If the market overstates the riskiness of a company's dream and your measurement informs you that this is not so, you will be rewarded for taking on that risk and see it decline over time as the benign scenario plays out.

Another pitfall is the emotion creep and the resulting parallax in your measurement. It is hard to leave exuberance at the door, but if no care is taken, your assumptions and estimations would unknowingly reflect this. It is acceptable to guess as long as you know you are guessing and the confidence probability of your guesses. There are also problems with heuristics, with regards to anchoring and adjustment, just to name a few. Much has been written about behavioural finance, which is a large topic in itself.

After all that, how much time should be spent on 'measuring' before taking action? My answer is just enough but never too long. There are many measurers out there with equal if not superior skills and information. Take too long and you will miss the boat.

Externals

Personal 'measurements' are not the only factors that matter in the eventual price discovery, so do other factors and the influence of other 'measurers'. With that awareness, let's begin to list a few.

First and foremost are brokers' reports, which institutional investors depend on. According to the paper "Strategic distortions in analyst target prices in the presence of short-term institutional investors" by P.Balinski, K.Stathopoulos and M.Walker, Cass Business School, analysts may cater to transient institutional investors in their estimates:

Our study identifies a new source of conflicts of interest in analyst research that originates from the ownership composition of a stock. We propose that short-term institutional investors favor optimistically biased research that facilitates profitable trades. Analysts cater to transient investors and issue more biased target prices (TPs), but not earnings estimates. Issuing more optimistic TPs, but not earnings estimates, reduces the likelihood investors will recognize analyst behavior. Consistent with this proposition, we find that the market fails to see through analyst incentives and reacts more strongly to target price revisions, but not earnings revisions, issued for stocks with high short-term ownership. Further, biased target prices allow short-term institutional investors to offload their holdings to retail traders, which suggests that analyst actions benefit institutional investors at the expense of retail investors.

Second is that analysts may not use consistent valuation parameters. This is from "Peering inside the Analyst 'Black Box': How Do Equity Analysts Model Companies?" by A.Markou and S.Taylor, Judge Business School:

We examine a set of equity analysts' private models from a large investment bank equity research department as a new way of understanding how analysts actually value the companies they follow. We identify their valuation approaches and use of inputs, including equity research premium, risk free rate and beta. We find that the analysts broadly follow textbook valuation approaches in their discounted cash flow analysis, including at least five years of explicit forecasts, a perpetuity-based terminal value and reasonable long term growth rate assumptions. But they are not always consistent in their use of valuation parameters. We hypothesise that analysts can manipulate their inputs to achieve desired valuation outputs while maintaining the appearance of theoretically sound valuation methods.

I have chosen these examples to show the possible fallibility of analysts, so that you may be aware if following their guidance, or take advantage of the temporary price distortions they may create. Having said that, many analysts perform their jobs splendidly.

The greater the number of 'measurers' for a particular company, the greater the confidence there is in the measurements; especially when the measurements more or less agree with each other. These tend to be straight-forward companies, such as motor retail and grocers. Should there be a premium for companies that are looked at more than the others? Richardson, Sloan and You (2012) find that changes in investor recognition, proxied by the breadth of ownership, dominate in the short term whereas fundamentals win in the long term.

Alternatively, conglomerates or any other slightly more difficult company valuation to crack would have less opinions published about it. This could be both a blessing and a curse. If you are patient, then it is the former. If you are in it for the short run, then it could well be the latter.

Lastly, different companies along with its share prices react differently to events. There are a whole slew of academic studies on company events. Practically, as much as you would like to *think* you can guess the probability of how the markets will react with news relating to a company, we all know it takes very little to spook or excite our fellow investors.

Keeping that in mind, it is useful however to estimate each company's reaction to changes in beta, interest rates, industry shock, changes in government policies or various other events.

Measuring the non-measurable

"We seek him here, we seek him there, those Frenchies seek him everywhere. Is he in heaven? Is he in hell? That damned, elusive Pimpernel!"

How do you measure that elusive attribute that makes a company one of quality, special and unbeatable? How do you quantify that exclusive branding or comparative advantage? What about providing convenience? That association is also part of branding. People love companies that make life easier, provide shortcuts or efficiencies for their lives. Just like intellectual capital, that is persuasive capital. How does one measure that?

There are also companies that by their nature require a different approach. For example, companies such as investment trusts, banks, insurance companies or brokerages. Included in this list are biotech and any frontier companies (usually technology) with blue sky aspirations, just to name a few.

The valuation of disruptive companies and the ones breaching the relatively infant world of internet commerce are a different kind of animal altogether. The breach and reach of these companies, just like the internet itself is hard to envision. Who would have thought of ASOS in 2000 will become the internationally popular site that it is now in 2014?

Two more things before I move on; one is that for each company there should be a measure of robustness, the ability to withstand downturn or to affect a turnaround, because as one knows, the paths to dreams do not always run smooth. Secondly, that operating efficiency is as well a mark of quality and should not be ignored.

Volatility and when the goal post moves

Understanding the volatility of the share price helps determine how accurate you can be at any given time. Profit takers also drive price temporarily down, perhaps making you doubt your valuation. Sometimes, depressed share price can stay low for quite some time and severely test your faith in your analysis. For some, others' panic selling while you decide to hold on to your shares (and conviction) is also something that can be gut wrenching.

At other times, shocks occur to either the company, its share price (sometimes on no news) or its dream. Dealing with shocks, determining what is temporary and permanent; revising valuation and how quickly to react (or not) is part of riding the volatility. Such is the life of being an investor.

Conclusion: Making a decision and committing

Practising the art of 'measuring', these are some of the issues one should address:

- *Your* 'deal-breaker' for a company
- The ability to change your mind with the revelation of new facts
- Being aware of your conviction level that is unhindered by the noise of the market
- Perhaps it would be better to determine your investment appetite by listing the desirable features of an ideal company that you would love to invest in, and adjust expectations accordingly

The business of interpreting dreams is a risky one. Like a lookout balancing up high on the ship's mast, you are constantly trying to make out how far away the land is, and whether the captain is steering the ship in the right direction.

Huge waves may throw you off the course; strong winds may blow you off your perch. Will the ship make it through the storm? Is land too far away a dream? You keep within you a mixture of hope and trepidation. You wonder whether the hull of the ship was not too damaged in the storm and quietly guess the distance to land, all the while, keeping your eyes on the horizon.

Investing is a serious pursuit of measuring the health of the company, the cogency of its goals, and pairing these measurements together to estimate the outcome. Embarking on this pursuit perhaps we too, as investors, will reach the land of our own dreams.

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