Common Sense on Common Stocks

7 Questions for Alexandre R. Kaufmann

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- Causes of misjudgement
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Mr. Kaufmann, why are you buying the shares of this company XYZ... 

...the value of the shares is going down?

Question 1: Price = Value?
Part I - Price and Value

Way of Thinking I - The Idealists
Central Idea: Price $\text{ALWAYS} = \text{Value}$.
Underlying assumption: the Stock Market is $\text{EFFICIENT}$.
Investment conclusion: it is $\text{not possible}$ to beat the stock market.

Way of Thinking II - The Realists
Central Idea: Price $\text{NOT ALWAYS} = \text{Value}$.
Underlying assumption: the Stock Market is $\text{NOT ALWAYS EFFICIENT}$.
Investment conclusion: it is $\text{possible}$ to beat the stock market.

What is the efficient Market theory?
(Wikipedia) In finance the efficient-market hypothesis (EMH) asserts that financial markets are informationally efficient, that is one cannot achieve returns in excess of average market returns. The EMH claims that prices reflect all publicly available information and that prices instantly change to reflect new public information.
Part I - Price and Value

If Mr. Kaufmann buys shares of company XYZ when the price is going down, that is because he thinks that:

\[ \text{PRICE} < \text{VALUE} \]

In other words, that the quoted price does not reflect the true economic value of the company. That is because he thinks that markets are not always efficient.

**Question 2:** why Mr. Kaufmann thinks that markets are not always efficient?

Steps for the formation of a price:
1. Gathering information - Standardized => Process tend to be efficient.
2. Interpretation of the information - Pretty individual => Process not efficient
3. Implementation into investment decision - Pretty individual => Process not efficient...

....and that is without mentioning the changing unexpected liquidity needs of the stock market participants.

Kaufmann Kapital AG for Incrementum Advisors AG - February 2012
There are 2 ways to make money by using stock market price volatility: the Way of Pricing and the Way of Timing.

Benjamin Graham (1894-1976), recognized as the father of value investing, first differentiated the two practices in The Intelligent Investor, a book he co-authored in 1949 with David Dodd.

"Since common stocks are subject to recurrent and wide fluctuations in their prices, the intelligent investor should be interested in the possibilities of profiting from these pendulum swings. There are two possibilities of profiting from these pendulum swings: The way of timing and the way of pricing. By timing we mean the endeavor to anticipate the action of the stock market - to buy and hold when the future course is deemed to be upward, to sell or refrain from buying when the course is downward. By pricing we mean the endeavor to buy stocks when they are quoted below their fair value and to sell them when they rise above such... We are convinced that the intelligent investor can derive satisfactory results from pricing. We are equally sure that if he places his emphasis on timing, in the sense of forecasting, he will end up as a speculator and with a speculator's financial results."

In the financial industry, there is a great confusion as to what is timing, and what is pricing! Stock markets intervenants hardly differentiate! I believe that 90% if not more of the intervenants are following the way of timing, without being even conscious about it.
Question 3: Alex, I still don't understand...What is the difference between the Way of Pricing and the Way of Timing?

The "Pizzeria" example: Imagine you live in a place that has many pizzerias and that you can buy or sell pizzerias like shares of food giant Nestlé for instance...

Now imagine that the summer has started badly, for it is raining all the time so that everybody prefers to stay and eat at home...

You go for coffee and meet with other pizzeria's owners to talk about the bad weather and the dramatic impact on the pizzeria's profits, pushing the price of pizzerias down...

...SO WHAT WOULD YOU DO?
## Part II - The Way of Pricing vs. Timing

### THE WAY OF PRICING

1. You try to assess how many pizzas and profits you would generate in your pizzeria under normal circumstances, i.e. when the weather is not particularly good or bad.

2. You don't try to anticipate when the weather will improve, but as you understand the business, you know that when the weather will normalize, profits will recover.

3. You are not scared because everybody is selling, but reckons the opportunity to buy eventually another Pizzerias if the price is going down further (increasing your Margin of Safety).

### THE WAY OF TIMING

1. You focus in the short-term and instead of normalizing earnings, you just focus on what the price will do tomorrow.

2. You try to anticipate when the weather will improve, by reading the same weather forecasts that everybody is reading (where is your Margin of Safety?).

3. You try to assess what the other Pizzerias owners will do, with the aim of anticipating their behavior, i.e. sell before the others (where is your Margin of Safety?).
Part II - The Way of Pricing vs. Timing

Question 4: What is the difference between an investor and a speculator?

Both investors and speculators display different attitudes when engaging with the unknown, representing here the future. The investor pursues the Way of Pricing, while a speculator pursues the Way of Timing.

**Investor**
- What the future represents: an unknown.
- Attitude when engaging with the future: he accepts the future is never clear.
- Underlying assumption: nobody has a crystal ball.
- Protection: with the use of a **MARGIN OF SAFETY**.

**Speculator**
- What the future represents: an unknown.
- Attitude when engaging with the future: he focuses on trying to anticipate it.
- Underlying assumption: he believes he can better anticipate the future as compared to the crowd in which he also belongs.
- Protection: "I know certain people very close to the situation...", or "I have this feeling that...".
Part III - Margin of Safety

Valuation: the Margin of Safety increases as the available price gets below the calculated value.

**Question 5:** how to calculate the value of a company?

The value of a business is determined by the cash inflows and outflows - discounted at an appropriate rate - that can be expected to occur during the remaining life of the asset. This method of valuation is referred to as the discount cash flow model.

**Question 6:** but you said investors should not focus on predicting the future?

*What is easier to do for the investor, to anticipate changes, or the absence of change?*
True, as we said the future **IS NEVER CLEAR**, and it is tricky to predict future cash flows. That is why an investor should mitigate the consequences of the unknown by **REDUCING THE AMOUNT OF UNKNOWN VARIABLES**.

He can achieve that by:

1) **Normalizing earnings:** by doing so, he tries to calculate the earning power of a company under normal circumstances, i.e. when business conditions are neither particularly favorable nor unfavorable (in our Pizzeria example, when the weather is neither particularly good nor bad).

2) **Focus on companies that are producing recurring cash flows,** well managed, simple to understand, and measurable from the perspective of the minority shareholder.

3) **Only take action when available prices is below the calculated intrinsic value,** to mitigate a) the occurrence of unpredictable events that could hamper operating performance, and/or b) human mistakes when assessing an investment candidate.
Part III - Margin of Safety

So, valuation alone is not enough! Because in order to value, you need to have a good idea about future cash flows taking into consideration that the future is never clear. For that you need, as already mentioned, companies displaying the following characteristics:

1) **Producing recurring** cash flows: it is easier to value a company that enjoys strong product visibility (water will always remain water) and fulfills a recurring need (you need to drink everyday, but you don't need to buy a new textile machine every day).

2) **Well managed**: the best company to own employs large amounts of capital at very high rates of return. To make it durable, you need **durable competitive advantages**.

3) **Understandable**: you need to identify the presence of competitive advantages (or the absence of it), and to grasp their durability. Otherwise how to have the conviction to buy when all the others are selling?

4) **Measurable** from the perspective of the minority investor: when the valuation becomes too sensitive from unpredictable parameters, when the disclosure level is not detailed enough or when the earnings visibility is just too small. Hence my reluctance to invest in firms active in the banking, insurance, (bio-) technology and pharmaceutical sectors.
There are different ways to look at an investment candidate. You can look at it from the perspective of the analyst, the portfolio manager, the client advisor, or the businessman (entrepreneur).

"To a man with a hammer, everything looks like a nail."

*Mark Twain*

The research analysts and client advisors tend to look at companies as pieces of paper that can be traded with the idea to generate commissions. Because that is how they earn money. So every reason to buy or sell is good enough as long as it can generate a trade! Some will use the DCF, but will change the price targets as often as they change their pants, along with the changing mood of Mr. Market.

A portfolio manager is financially interested to increase its assets under management. So they tend to look at companies as a way to increase their assets under management. The fastest way to increase AuM is to maximize short-term performance. They have a short-term financial incentive to follow the way of timing. That is why most of them fail to beat their index over time.
Finally: "Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally." - John Maynard Keynes

Question 7: So what is the right investment attitude?

An entrepreneur recognizes that behind the equity market and the stocks, there are people. When you buy shares of the company XYZ, you invest in the people who run that business. An entrepreneur is genuinely interested in businesses.

I believe that in order to truly understand a business, you need to look at it with the eyes of a businessman.

Would you sell your law firm because of concerns of a real estate bubble in China? Do you call your real estate agent to inquire about the market price of your house twice a day? And by not calling your real estate agent twice a day, are you preventing the price of your house from increasing over time?

Why would you think differently if it is your business or your investments?
Part IV - The Attitude

Finally, be aware of the numerous causes of human misjudgments.

Charlie Munger, Vice President of Berkshire Hathaway, enumerated many causes of human misjudgements in his Poor Charlie's Almanack.

These include: the award and punishment superresponse tendency, the liking/loving tendency, the doubt-avoidance tendency, the inconsistency-avoidance tendency, the deprival-supperreaction tendency, the influence-from-mere-association tendency, the social-proof tendency, the contrast-misreaction tendency, the stress-influence tendency, etc. etc. etc...

There are many !!! So...

"Above all, never fool yourself, and remember that you are the easiest person to fool." - Charlie Munger
Inflation, financial repression, debt problems among certain states, contradicting macroeconomic data and varying geopolitical tensions across countries, that is the context in which we live in. The stock market will be sometimes too pessimistic, and sometimes too optimistic. What is relevant is not the stock market. What is relevant for us are certain of our selected companies and their entrepreneurs. Thanks to their visions, ideas and work, we intend to protect our purchasing power over time, and to take financial advantage of the incremental value they are about to create.

We at Incrementum advisors AG being truly independent, do follow the "entrepreneur approach". Our goal is to protect and grow your wealth safely, steadily and incrementally. Our conservative approach is based on value. Our investment decisions are based on a rigorous due-diligence. Our clients do confirm to us that working with a truly independent Asset Manager makes a difference.

Alexandre R. Kaufmann