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Managing risks in stock selection

Managing risks in stock selection:

valuation risk, management execution risk & margin-of-safety

Understanding “known” and “unknown” risks

Risk and reward are two sides of the same coin. Whilst the success of capital allocation decisions and the strength of competitive advantage drives the outlook for shareholder value creation, conversely, they are also strong proxies for understanding the level of “known” and “unknown” risks in a stock.

Capital allocation decisions present risks due to management execution going wrong and destroying shareholder value.

Excessive optimism about a company’s competitive advantage poses valuation or duration risk.

It is important to have a grasp of another important “unknown” - what of the good or bad news Mr. Market has priced in into the stock already? Our proprietary estimate of embedded expectations captures the margin-of-safety in a stock.

Valuation risk: Using implied competitive advantage & I-EVA to manage risks

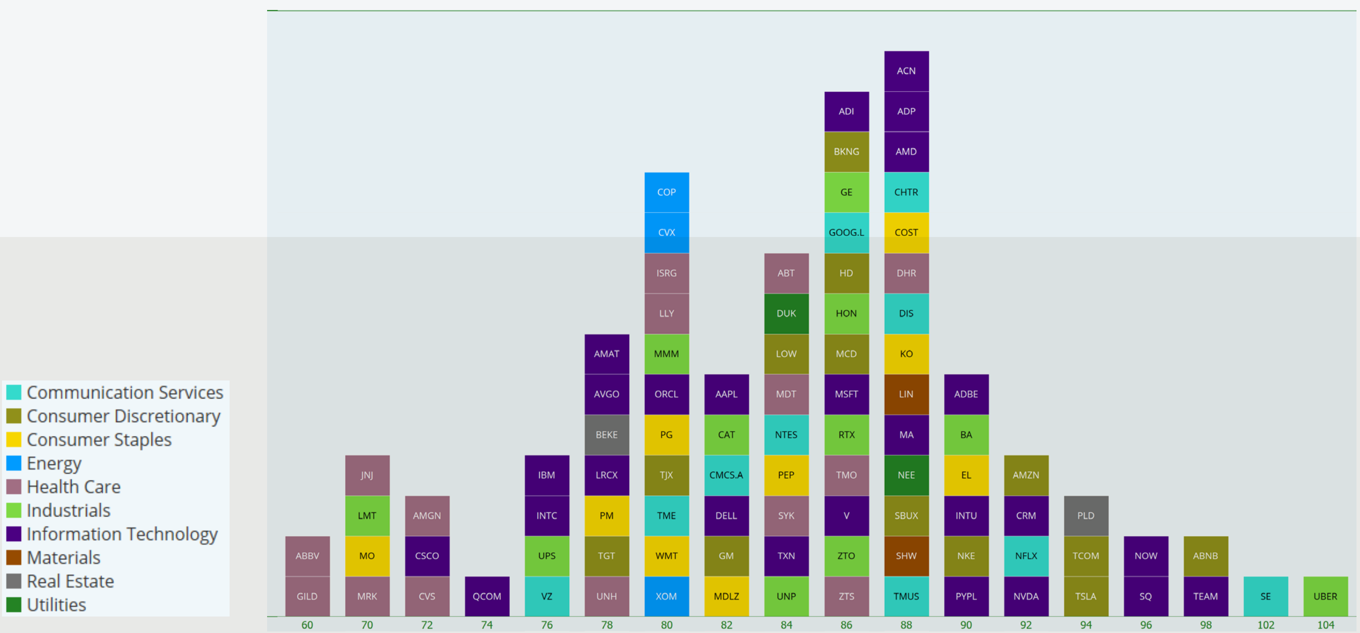
Implied competitive advantage represents the future value (the "known unknown") component of a stock's valuation as implied in management guidance/consensus forecasts.

On the one hand companies with a high implied competitive advantage are expected to have better visibility and predictability in cash flow generation, which is likely to persist over a longer duration. The longer this number, and the supposed visibility in the future cash flows, the higher the multiple.

On the other hand, since it is impossible to ascertain what will happen in the future, as exogenous factors such as wars, pandemics, competitive challenges and even company-specific factors can undermine fundamentals, the longer the implied CAP, the higher the risks attached to the stock - the duration risk for stocks.

Long competitive advantage periods and weak forecast I-EVA outlook indicate especially high duration risks, and such risks could be magnified by various unpredictable exogenous factors. While not immune to the external risk, companies with short competitive advantage periods are more likely to be more impacted by company-specific factors and, hence, carry a lower risk profile.

Implied competitive advantage of top 100 US cos (October 2021)



Management execution risk: using capital allocation & I-EVA to manage risks

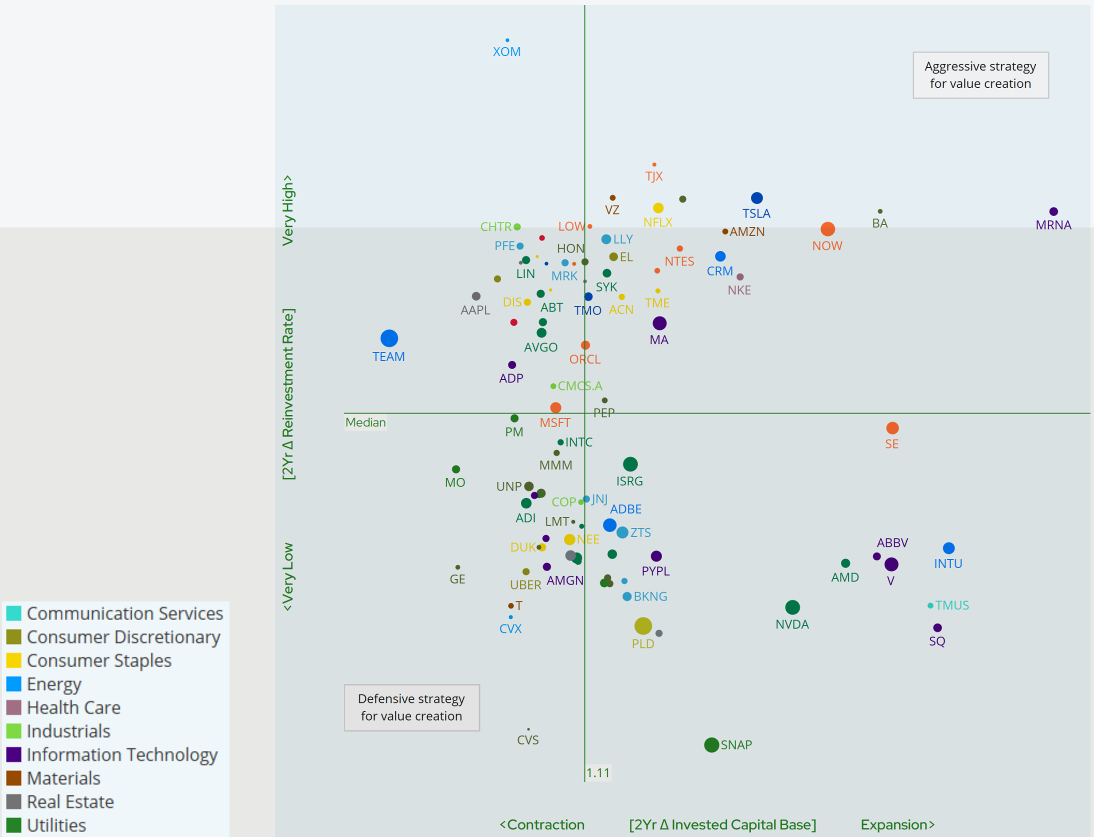
Management tries to maximize shareholder value creation through an optimal allocation of invested capital, but they can be value destroyers. In allocating capital, there are four main options for management teams: (1) invest in the business and grow organically through capex, usually by expanding capacity (2) invest in other businesses and grow inorganically through acquisitions (M&A) (3) pay down debt (4) reward shareholders.

Management can make serious errors in capital allocation decisions that can destroy value, particularly with the deployment of capital into M&A, capital expenditures, R&D, and the use of net working capital that are not efficient. (Repaying debt holders and returning capital to shareholders will not destroy value, but it could put the company in harm's way if it is done with little regard to a future cash position.)

Are management capital allocations putting a company's shareholder value creation prospects at risk? The outlook for I-EVA gives a basis for comparison of the risks. For instance, heavy expansion of capital base and high reinvestment rates, and weak I-EVA outlook indicate higher risks.

Companies pursuing highly contractionary strategies, on the other hand, are less likely to suffer from capital allocation risks.

Capital allocation of top 100 US cos (October 2021)



Margin of safety risk: using embedded expectations to manage risks

"The single biggest error in the investment business is a failure to distinguish between fundamentals and expectations. These are two different things"

Michael Mauboussin

Intelligent investing is about identifying the gaps which may exist between expectations and forecast fundamentals. In doing this, it is common for investors to pose the question - "what's baked into a stock price"? In other words, to what extent are the forecast fundamentals accepted by the Mr. Market as an inevitability, and to what extent is that certainty embedded into the share price? The risk to investors is overpaying for a stock when the price has already run up to reflect the "good news".

Traditionally answers are couched in terms of valuations - either absolute and relative to the firm's financials, or as a relative metric compared to peers; or even in terms of potential news flow that may or may not emerge. Moreover, comments like the "stock is trading on low PE, and much of the bad news is in the price" are not helpful, as a low-priced stock can potentially retreat further.

So how can this seemingly subjective measure be captured as a metric which can be useful in portfolio management?

"Stock prices are the clearest and most reliable signal of the market's expectations about a company's future performance. The key to successful investing is to estimate the level of expected performance embedded in the current stock price."

Alfred Rapport and Michael Mauboussin

The most important place seek out embedded expectations is in the share price itself, and we calculate the momentum in the share price. Has the market rewarded an increase in forecast I-EVA (incremental shareholder value creation) with a corresponding change in share price? Or are embedded expectations too low as the market is not trusting of consensus optimism?

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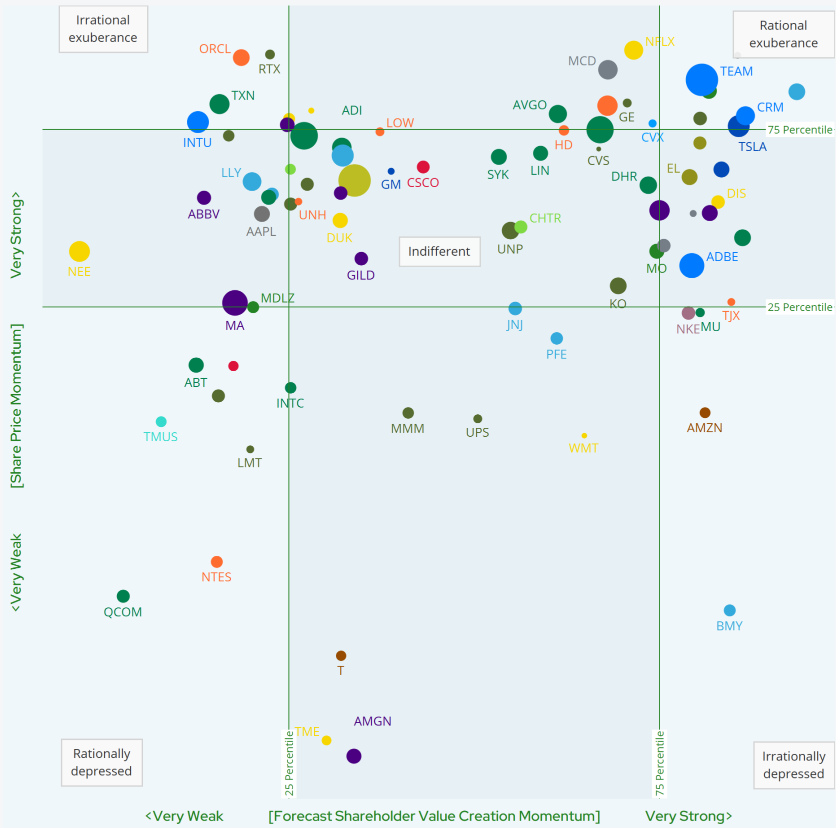
Embedded expectations: top 100 US cos (October 2021)



To capture this, we estimate the embedded expectations, a ratio of recent momentum in share price compared to the forecast incremental value creation (I-EVA). This ratio highlights stock price bubbles or the stocks trading on distressed valuations. By bringing I-EVA into focus in this framework, we can sift the "rationally-exuberant" from the "irrationally-exuberant" stocks (and the "rationally-depressed" to the "irrationally-depressed").

The high risk stocks are to be found in the "irrationally exuberant" section, where the share price momentum has vastly outstripped the outlook for value creation. The "rationally depressed" are stocks where the outlook for value creation looks poor and this is clealry indicated by the depressed momentum in the share price.

Fo as long as the story of value creation and the length of competitive advantage holds strong, low-risk stocks can be be found in the "rationally exuberant" section. These stocks also carry significant duration risk due to exogenous factors such as war, pandemic etc. Another low-risk section is the "irrationally depressed" areas where Mr Market is, perhaps, givin much credence to an improving value creation story.

The "indifferent" may be seen as the "fairly priced" - i.e, the share price momentum corresponds to the momentum in the outlook for fundamentals (I-EVA).

Disclaimers

Plain english

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