Bottoms-up – The Importance of Fundamental Analysis

October 2010

Michael D. Axel, CFA
Jacob D. Benedict
David J. Manger

Watch CNBC all day and you will no doubt hear analyst after analyst make an over-arching statement about the health of the economy or the state of affairs in Washington and then directly proceed to a recommendation to buy or sell stocks. This seems logical on the face of it, and investors are often led to the assumption that there is a one-to-one correlation between economic growth and stock market returns. Unfortunately, such reasoning is seriously flawed. When asked to describe our investment philosophy, we always include the fact that we are bottom-up investors. Indeed, bottom-up investing is core to our investment decision-making process. In our estimation, it also places us in the minority within the investment community, which too often practices and preaches a top-down investment approach.

What is the difference between top-down and bottom-up investing? Imagine that a farmer gives two neighbors the opportunity to purchase the harvest from one of his plots of land. The quoted price seems approximately fair, but the attractiveness of the deal will depend on the quality of the produce. The first neighbor conducts an intensive survey of the factors that influence crop quality. He studies the weather and rain patterns for past and present seasons, tests the soil of the area, researches the fertilizers that the farmer used and examines past crops. The second neighbor takes a simpler approach – he spends a week walking through the cornfield examining stalks of corn by hand (the crop is ready to be harvested). Which neighbor has a better chance of identifying a fair deal? While the first neighbor may have used sophisticated techniques and scientific processes, it is incredibly difficult to account for all of the factors that could impact the success of the harvest. What if the farmer made an error during planting season? What if a foreign species unexpectedly infested the harvest? The second neighbor, while using a more basic process, arrives at a much better conclusion – his examination of a statistically significant portion of the crop allows him to state with confidence whether he is getting a good deal or not. This doesn't mean that the first neighbor's studies aren't important or relevant, but they are unable to control for all of the factors that impact the outcome of the crop. [We apologize to our friends in agriculture for any gross inaccuracies of their industry for the purposes of this example.☺]

Macro (top-down) analysis in investment decision making can be quite dangerous. There are simply too many variables to account for before it can yield actionable advice. The abysmal record of economic forecasters should give pause to anyone who thinks of using such approaches to determine investment actions. Most importantly, it often leaves out the most critical variables. Suppose that someone offers to sell you a business for a price of $X, but says that he will only give you one piece of information about that firm. Many will consider asking about market share, growth opportunities, management, industry dynamics, etc. But the most important variable is likely to be annual free cash flow produced. If a business is shrinking 5% per year it is easy for a top-down thinker to dismiss the company as a bad investment. But if the company produces $100 in cash flow this year and you can buy it for $100, then it is an incredibly attractive investment. It all depends on the *valuation* of the business.

Investing is nothing more than giving up current consumption, in the form of dollars, for more future consumption, or more future dollars. As long as the forecasted path of future cash flows, adjusted for inflation, risk and opportunity costs, are significantly more than the present sum required to purchase those cash flows, then investment is attractive no matter the particular path of those cash flows.

We have been pessimistic on the economy for some time now and we continue to believe that the recovery is likely to be difficult and prolonged. But that does not tell us whether we should invest in stocks or not. We often quote Warren Buffett's prescient words from his 2008 shareholder's letter:

> We're certain, for example, that the economy will be in shambles throughout 2009 – and, for that matter, probably well beyond – but that conclusion does not tell us whether the stock market will rise or fall.

Now this doesn't mean that macroeconomic research is unimportant or irrelevant, but only that it should be a secondary consideration when investing. The future path of a company's cash flows will no doubt be determined by economic growth, inflation and government policy. In order to craft robust portfolios, we need to think about potential economic shocks that could harm investor wealth. But such areas are difficult, if not impossible, to forecast with any meaningful accuracy. What's more, even if you are right on the forecast, you can be wrong on the conclusion – what matters isn't the future path of economic events, but the future path of economic events *relative* to the expectations currently priced into the market. The economy could turn out to be horrible, but if it is still better than the implicit forecasts in the prices of stocks, then prices will likely rise.

Take the early 1980's as a prime example. There were more than enough reasons to be bearish. Interest rates reached 20%, inflation surpassed 10% per year, the oil embargo convinced the nation that oil prices would continue to escalate from already high prices and the Cold War's threat of nuclear attack remained real and present. Yet an investment in the S&P 500 in July of 1982 would have returned 18.9% annually through September of 2000 and still 11.6% annually through September of 2010, for the chief reason that stocks were priced at doomsday levels (approximately 6x earnings).

Accordingly, we see ourselves first and foremost as bottom-up business analysts focused on the valuations of individual companies. We spend the bulk of our time studying businesses – reading their public reports, speaking with management teams and learning their industries. We have an educated opinion on how the economy may develop, the threat of inflation and the impact of certain public policies, but we also carry skepticism that we can forecast such things with any useful accuracy. Our investment decisions are based upon the presence of a margin of safety – if we can assemble a portfolio of stocks that are priced at a significant discount to what we calculate as their intrinsic value, formulated using conservative estimates and typically based on free cash flows, then we will be confident investing in that basket of stocks, even if the outlook for the economy grows dim. Unfortunately, while such thinking has proven to be intelligent and successful over the long-term, it doesn't make for good TV.

We see ourselves first and foremost as bottom-up business analysts focused on the valuations of individual companies.

Sincerely,

Michael D. Axel, CFA
Jacob D. Benedict
David J. Manger