AMI Investment Management
Registered Investment Advisor

White Paper

Quality and Value: AMI on Stock Selection

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In his 1996 letter to Berkshire Hathaway shareholders, Warren Buffett wrote:

> *Intelligent investing is not complex, though that is far from saying that it is easy…To invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well-taught courses – How to Value a Business, and How to Think About Market Prices.*

This white paper is the second in a two-part series aimed at tackling these two courses. The first white paper, titled "Mr. Market: Friend or Foe? (How the Long-Term Investor Should Think About Volatility)", discussed how investors should think about stock market prices and their regular gyrations. This white paper progresses to the natural follow-up question: assuming the investor makes a commitment to investing in stocks, what stocks should actually be chosen, and how?

Introduction

There are countless theories outlined in books, interviews, blog posts, etc. that purport to hold the keys to successful stock selection. These theories vary from studying supposed patterns in past stock price charts to buying stocks with the highest dividend yields. In most cases, these theories are much too simple. They look for patterns in past data and assume those patterns will repeat. *Simple historical patterns nearly always fool the practitioner*.[1]

In this white paper, we hope to succinctly describe the theories and practices that AMI uses to select stocks. This is an ambitious undertaking given the complexity and nuances of stock selection. But it is important endeavor, not only because our clients should understand the framework that we use to build their portfolios and protect and enhance their wealth, but because the process of explaining that framework is a valuable tool for testing and improving it.

Investing is often made more complicated than it really is. At its heart, good investing is simple, as Warren Buffett demonstrated with a single paragraph:

> Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily-understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now. Over time, you will find only a few companies that meet these standards – so when you see one that qualifies, you should buy a meaningful amount of stock…

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[1] There are several reasons for this, one being what the famous investor/trader George Soros calls "reflexivity" – unlike physics, the behavior of participants in economic systems impacts the system itself. For instance, if all investors observe that small-cap stocks have higher returns than large-cap stocks, they may pile into small-cap stocks. But by piling into small-cap stocks, they may render the original observation invalid. Such "dynamic" systems became much too complicated to predict using simple rules like "invest in small-cap stocks." As Charlie Munger once observed: "If you want a formula, you should go back to graduate school. They'll give you lots of formulas that won't work." Berkshire Hathaway 2018 Shareholder's Meeting.

> You must also resist the temptation to stray from your guidelines: If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes. Put together a portfolio of companies whose aggregate earnings march upward over the years, and so also will the portfolio's market value.[2]

The key to investing is simple: seek to buy and own great companies at reasonable prices. But simple doesn't mean easy, it just means uncomplicated. It isn't hard to understand what constitutes a healthy diet, but that doesn't mean eating healthy is easy.

Underlying Buffett's approach are his two foundational commandments for investing: "Rule No. 1: Never lose money. Rule No. 2: Never forget rule No. 1." Now this does not mean that investors should never have a losing investment – mistakes are an unavoidable part of investing. But instead it is meant to emphasize that many investors get themselves into trouble reaching for returns or chasing tips and fads. The investor Morgan Hounsel writes:

> The counterintuitiveness of compounding is responsible for the majority of disappointing trades, bad strategies, and unsuccessful investing attempts. Good investing isn't necessarily about earning the highest returns, because the highest returns tend to be one-off hits that kill your confidence when they end. It's about earning pretty good returns that you can stick with for a long period of time. That's when compounding runs wild.[3]

This is why AMI, unlike many investment outfits today, spends so much time researching and selecting the stocks that we purchase and hold in our portfolios. There is no guarantee that our portfolio of stocks will outperform the market. Indeed, such a feat is not easily accomplished. But by knowing and understanding what we own we have the courage and conviction to persevere and move forward during periods of market turbulence. So how do we actually go about *selecting* what businesses we own?

Quality and Valuation

Our approach to stock selection is based on two foundational variables: business quality and valuation…

To see the rest of this white paper please email Ryan Kay at ryan@AMIinvestment.com.

[2] Berkshire Hathaway 1996 Annual Report.

[3] "The Psychology of Money" by Morgan Hounsel, June 1, 2018.