How Do We Find Good Stocks to Buy?

During a meeting in mid-October, a client asked us to explain, in practical terms, how we find the stocks that we buy, which prompted an interesting discussion. He was not asking about our style, philosophy or core beliefs, rather, he was simply curious about the practical steps we take on a daily basis to find stocks that suit our method.

This was a great question to ask. As clients do not sit with us in the office all day, our processes are not entirely visible. We think it is worth answering his question again, in print format, so that all of our readers gain a better understanding of our business. Later in this edition of the Armstrong Schmidt Perspective, we will discuss transactions for our Total Return Portfolio and High Yield Portfolio for the third quarter of 2013 (Q3).

So, how do we find the stocks that we buy?

1) We begin with the end in mind.

The potential investable universe for North American stock investors comprises around 5,000 publicly traded companies that are listed on senior stock exchanges like the NYSE and TSX and thousands more that are listed on more lightly regulated junior markets. Following this many companies is unmanageable.

As American author Stephen Covey suggested, we "begin with the end in mind." The goal of our stock research process is to find undervalued, high-quality companies that have market capitalizations in excess of $200 million dollars. This means we can quickly eliminate thousands of companies from our investable universe, as it makes no sense to spend valuable research time on marginal companies that we are virtually certain not to buy for clients.

It is difficult to quantify our investable universe exactly, but we would estimate that there are around 2,000 companies in total that may be worthy of research using our methods and focus. By knowing who we are as investors, we quickly eliminate well over half of North American public companies from consideration.

2) We read incessantly.

We believe you have to read incessantly to be a great investor. We do not rely on a single source of ideas. We are always reading new information from countless sources, including company filings, analyst reports, newspapers, websites, stock screeners, books, presentations and other materials. We also track what some other successful U.S. investors are buying and selling. Admittedly, most of our reading does not result in immediately actionable investment ideas – it is better described as knowledge building and "tire-kicking". It is nonetheless time well spent, as stored investment knowledge can be extremely useful years down the road.

3) We maintain a watch list of promising companies.

A watch list is simply a list of companies in a format that provides access to share price quotations and company-specific news. Our watch list contains hundreds of companies. It is the result of our reading and research, and it is always changing. When we find a company interesting, we add it to our watch list and research it further. If we decide it is ultimately of no interest, we stop following it and delete it from the list.

Maintaining a watch list is essential, as it allows us to efficiently monitor numerous companies and ultimately spot more opportunities. The same company with the same business can easily be a buy at one price and a sell at another price. In our Q1 2013 Newsletter, available on our website, we discuss some specific examples of how we used our watch list to find opportunities.

4) We use a checklist.

The use of checklists has been shown to improve results in fields like aviation and medicine. Checklists benefit investors as well. If we believe that a company's shares are a potential buy, before we invest, we run the company through our proprietary checklist. This ensures that we measure all companies against all of our criteria. It also enables us to compare apples and oranges, as we can run an oil company and a healthcare company through the same checklist.

There are three categories of questions on our checklist – questions about the quality of the company's business, questions about the valuation of the company's shares, and portfolio management considerations, such as whether the company contributes to or detracts from portfolio diversification. When we identify a high quality business that we believe is undervalued, and it contributes to portfolio diversification, we are probably buyers of the shares. Conversely, if a company fails to score highly on our checklist, we have to consider whether it truly suits our method, and it is unlikely that we will buy. Our checklist therefore serves as both a risk management tool and a reminder to apply our investment criteria consistently.

5) We discuss and debate.

It is possible to be a good investor working alone, and it is also possible to have good results after running decisions through a multi-person committee. Our circumstances are that there are two of us. Our internal discussions add value to our investment decisions. When our discussions turn to debates, it is usually because one of us thinks that the company at issue is either: a) not high quality enough as a business; or b) not cheap enough; in other words, not undervalued. When we both agree that a company is a buy, it is usually a good indicator of investment potential.

6) Concluding thoughts.

Hopefully what we have shared about how we find stocks that fit our method is helpful and not too self-referential to be interesting. We have focused more on practical actions than philosophy and beliefs, as we already address those matters frequently in our publications. We are happy when clients ask us about our process, as we believe that the more a client understands what we do, the more value they will see in our services.

Q3 Transaction Summary

CSX Corp.

North American railway stocks have had a strong run over the past three years, which has been justified by their business results. The investment potential of the industry has improved over time.

In 1900, there were over 100 railway companies in North America. Today, a handful of large players control the prize assets. The industry was deregulated significantly in the 1980s and 1990s, allowing for the strong financial performance we see from the key companies today. Prior to deregulation, railways were often forced to maintain unprofitable routes for the benefit of their customers.

In recent years, the strong competitive position of the railways has become clear to investors. Traffic congestion in major North American cities has put the trucking industry at a disadvantage. Rising oil prices have highlighted the fuel efficiency advantage of railways over trucks.

Also, intermodal freight transport continues to grow. “Intermodal” refers to the use of shipping, rail and trucking to move a standardized container without handling the contents while changing the mode of transportation. Decades ago, railways realized that they could double-stack shipping containers on a single

rail car, increasing freight volumes and efficiency. Railways continue to modify their lines today so that they have sufficient vertical clearance to double-stack containers.

Even with all of these positive characteristics, we would be reluctant to call a railway a “great” business. We do think that owning key pieces of rail infrastructure can be a “good” business, but there are challenges.

First of all, railways are quite capital-intensive, as track maintenance and upgrades are constantly required. Second, the industry is cyclical, as its fortunes rise and fall with the overall economy. For example, in a recession, railways will suffer due to reduced demand for commodities and manufactured goods. Third, there are always competitive and regulatory challenges. The trucking industry is trying to lower its costs, and railway regulators, in response to recent rail accidents, could impose costly new standards.

On August 7, we purchased shares of U.S. railway company CSX Corp. (NYSE:CSX) for the Total Return Portfolio at a price of US$25.41. The company’s network serves 23 states in the eastern U.S., including some of the most densely-populated areas. We believe that EPS growth could average around 10% per year over the next several years, in part due to share buybacks. Trading around 14 times 2013 EPS estimates and paying a dividend of around 2.4%, CSX looks like a solid multi-year investment.

Coca-Cola Co.

Coca-Cola is an excellent business with high profit margins and valuable brands. The company owns 16 individual brands that generate at least US$1 billion in revenues, including Powerade, Sprite, Minute Maid, Dasani and Vitamin Water. The company claims to have the world’s strongest distribution system, which may be correct, given that its products are sold in over 200 countries.

It is easy to make a case for business quality but slightly harder to make a case for undervaluation. We bought Coca-Cola shares for the Total Return Model at US$40.35 on July 30 and for the High Yield Model at US$38.00 on October 1, we paid around 18-19 times expected earnings for 2013. This is a somewhat high multiple for a company that may only be capable of 5% annual revenue growth and 8% annual EPS growth in the coming years, but we were willing to pay up, due to the high probability of a good long-term outcome.

Also of note, Coca-Cola shares pay a dividend of nearly 3%. The company has raised its dividend for 51 consecutive years. The company is also using some of its free cash flow to repurchase shares, a shareholder-friendly move.

National Oilwell Varco Inc.

National Oilwell Varco has become a substantial holding in the Total Return Portfolio, with a weighting around 5%. In our last quarterly newsletter, we discussed the reasons for our initial purchase of the company's shares at US$68.84. On August 19, we bought more shares at US$71.43. The company is a worldwide leader in the design and manufacture of oil and gas drilling equipment, so it is classified as an energy sector holding.

Suncor Energy Inc.

Near the end of Q3, we bought shares of Suncor for the Total Return Portfolio at a price of $37.31. This large-cap Canadian oil producer is vertically integrated with production, refining and a network of gas stations. The key factors that persuaded us to act were: a) a low price to cash flow multiple and strong balance sheet; b) over 30 years of oil reserves; c) a commitment to shareholder friendly actions such as dividends and buybacks; and d) an ability to access global oil pricing with over 90% of production, minimizing risk from Canadian oil transportation constraints.

Sales

During Q3 we eliminated our Total Return Portfolio position in Canaccord Genuity Group Inc., and trimmed our positions in Diana Shipping Inc. and Silver Wheaton Corp.

Conclusion

With Q3 completed, and the year to date results looking quite positive, we are optimistic that we can finish 2013 on a strong note. As always, we thank you for your business, and invite you to contact us with any questions or comments.

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