Our 9-Step Investment Process – Part 3

We now continue with the third installment of how we operate and run our investment management business. Following on from the second installment, we shall discuss these activities next:

7. **Taking an Initial Position in the Fund**

- We start with ~3% weight in the portfolio;
- We reassess our thesis and the price after one or two quarters;
- Thesis is still relevant and price still offers an attractive risk-reward profile: Increase weight to ~6%; OR
- Thesis still holds, but the price is not low enough anymore: We wait to buy more or sell the position if it reaches full value.

× Thesis does not hold anymore: Sell

8. **Following the Businesses We Own**

- Looking to keep an edge over other investors in the businesses we own;
- Updating our information and models at least quarterly; and
- Staying updated on management's vision and capital allocation decisions.

9. **Exiting the Stock (Selling)**

- Two scenarios can make us sell an investment:
    - Price reaches full value OR
    - Investment thesis is not holding anymore.
- After selling, we put the stock on our wish list and revisit it if the price comes down and our investment thesis still holds.

We have explained to you the four concepts that drive our ethos, which are Independence, Concentration, Transparency, and Performance. Following from those drivers, we then have our ongoing nine-step methodology for how we actually decide what stocks to buy and what to leave aside. Our previous installment discussed the first six steps, which are:

1. **Our First Hurdles**
2. **A Business Model that We Can Understand**
3. **Discussing the Idea with the Team**
4. **Building the Financial Model**
5. **Reaching Out to Management**
6. **Find the Optimal Risk-Reward Price**

Each part of our process is a stepping-stone to the next, and we have developed this framework from our exhaustive research and extensive experience working in finance, i.e. because we know it works. (Again, in order to help us with the technical terms used hereafter, I will provide links for certain words that you can click to read on Investopedia, our preferred resource for providing accurate, financial definitions.)

7. Taking an Initial Position in the Fund

In Step 6, we discussed how we derive an optimal entry price at which we will start purchasing shares. Our fund holds about 15 stocks in the portfolio, which would average out to about a 7% weight if we bought the same percentage for each company. And, for Step 7, we do not purchase the full weight at the beginning, but rather we buy a smaller amount, say ~3% of our portfolio, as we begin to deepen our understanding of the company and industry in question. And that's how we start!

From there, we patiently track its performance, although again, we do not concern ourselves overly with daily or short-term price fluctuations. Spending all your time watching the numbers flicker across your screens is pretty mind-numbing, and somewhat unnecessary. Successful investor discipline is all about holding your nerve when it seems things are crashing down around you. Financial media, like all reportage these days, is prone to hyperbole and outlandish headlines, which can break the retail investor's will. Our mantra is to hold the course for as long as our thesis remains valid before doing anything decisive. Worst of all, the current political environment in various countries is destroying many traditional mechanisms for analyzing markets, and the gyrations we witness due to trade wars and the demise of international agreements have upended the market's hitherto predictability and introduced a randomness that undermines the best laid plans. Nonetheless, we persevere as these perturbations will fade away in time, while we also take timely advantage of volatility, any mispricing of stocks, and/or large panic moves.

If we find that the business valuation is appreciating and performing largely as we anticipated, then we will add to our position after a quarter or so. Again, our heavy work is done when we initially determine what is the fair price at which we will buy in. As long as we have not purchased the stock too expensively, we should have a buffer for any weakness in performance. One frustrating aspect of investing in equities is that you can actually be right, but be too early to the market with your idea. This means that sometimes it takes much longer for the market to see and understand what we do because our research dives deeper than other researchers do, and this can add to the complexity of making positive returns.

Of course, we do not want to begin investing in a company only to exit shortly thereafter, but as you can see, we do reserve the right to do so as new information become available. This brings us to another legendary statement, which speaks to the sort of thinking that seems in short supply these days:

> "When my information changes, I change my mind. What do you do?"

It is unclear whether Mr. Maynard Keynes or a Mr. Paul Samuelson uttered this famous sentiment, but it is amazing the difficulty humans naturally have in letting go of loved opinions, no matter how powerful is the extant evidence to the contrary! This phenomenon, which is called "confirmation bias", has been studied and discussed plenty in recent years, especially in Kahneman and Tversky's book "Thinking Fast and Slow". This powerful, subconscious trait is why people have a hard time adapting to new information and changing their closely held beliefs. Indeed, as per Wikipedia:

> 1. Confirmation bias is the tendency to search for, interpret, favor, and recall information in a way that confirms one's pre-existing beliefs or hypotheses.
> 2. People also tend to interpret ambiguous evidence as supporting their existing position.
>
> https://en.m.wikipedia.org/wiki/Confirmation_bias

These biases are the root of so much poor decision-making in society. We strive to avoid such close-mindedness and use a team-based approach to remove the unconscious blinders that hamper clear thinking by always challenging our own theories and investment rationales without fear or reprisal for sharing differing opinions.

8. Following the Businesses We Own

This next step is as straightforward as the bullet points describe. Now is when we are like bakers, waiting for our bun in the oven to rise and bake to perfection, i.e. to yield positive returns and double in value over a three-to-five year horizon. During this stage, we look to keep an edge over other investors in the businesses we own by updating our information and models by reading their quarterly and regular financial statements from cover-to-cover. This requires us to stay updated on management's vision, which we do via calls and meetings with their C-level directors and investor relations teams, as well as staying abreast of industry and market developments. We constantly collect and collate information to ensure our investment thesis remains valid.

9. Exiting the Stock (Selling)

This last activity is so important, yet almost always overlooked when speaking with investment advisors. And I regularly liken this to medical doctors and how terribly they work at prescribing psychiatric medication. The investment advisor and the doctor are always very quick to sell you something and have you buy what they offer. They very rarely explain to you in no uncertain terms about when will be the time to end the process and exactly how that will occur. It can often seem like they are there to get you started, but then they leave the back end of things ill defined. We work in a very different manner and spell out clearly how we exit our positions. It is a given that our share price is a "moving target", which means that number will move with time, i.e. it can go up or down depending upon circumstances. Ergo, we will sell once we reach our price or if the investment thesis changes. Which, if we are simply seeking to double our investment, is rather straightforward, i.e. if we buy at $10/share then the best case scenario is that we expect to sell when it reaches $20/share.

And, if we are successful and achieve our aims, then we will take our profits when we get to the high price. However, once we exit the position, we do not necessarily give up on the stock entirely and forget all about it. Instead, we continue to assess the opportunity to remain invested at a smaller percentage. One of the clever and underappreciated tactics we deploy is to stay up-to-date with stock names we once owned, as there are always occasions when they might descend again in price and become an attractive value investment for us once more, which we call "double-dipping". We do such extensive work and preparation to get comfortable with each stock that it makes beautiful sense to re-use that work if circumstances change again in our favour. That quote from Keynes about updating conclusions as circumstances dictate is also very apropos here.

So that is how we do it! Nine straightforward steps that we constantly employ, and that we often "rinse and repeat". What do you think?