

## **Evolution of a Value Investor: It's All about the Process**

*By Zeke Ashton*

One of the insights that I've gained from more than a decade of diligent study is that successful investing over the long term is all about creating a good process and then constantly working to make it better. At its very essence, the business of investing is the business of making quality decisions. We therefore want to develop a process that leads to good decisions, minimizes poor decisions, and ensures that we get maximum value from the decisions we get right while minimizing the damage we suffer when we are wrong.

The first step is to understand what factors that an investor can control, and just as importantly, what cannot be controlled. It is one of the paradoxes of investing that the one factor we'd most like to control (i.e., short term performance) is the one thing we cannot control, simply because we cannot control what other investors are willing to pay for our stocks in the next week or month or year. All we can control is the quality of our decisions – make good decisions and good performance will inevitably follow.

### **The Four Decision Factors**

One of my rather surprising conclusions regarding the investing process is that there are really only four decision points an investor can control. Three of these are on the “buy” side of the decision cycle, and only one of them is on the “sell” side of the equation. Boiled down to the most simplistic terms, the three “buy” side decisions are:

- Identifying what specific security to buy;
- Determining what price to pay;
- In the event the stock becomes available for purchase at or below the designated price, how big a position to take;

While a whole lot of thought has to be put into those three decisions, the end result is that the combination of these three decisions results in the purchase of a security. To “buy well” requires that an investor have a plan to decide what stock, what price, and what size. I suspect that many investors, even professionals, buy stocks without an intellectual framework in place for these three facets of the buy side decision. The sell side process is shorter but not necessarily easier. Once a security has been purchased, it seems to me that an investor has far less control on the “sell” side: he or she can decide to sell some or all of the stock at the current price or to hold the stock in anticipation of getting a higher price at some point in the future.

## Improving Decisions at Each Point in the Cycle

It is my opinion that the key to becoming a better investor is to learn to improve the decisions made at each point in this cycle. One of the fascinating aspects in which investing is as much art as science is that every successful investor will develop a slightly different way of approaching the problem. The process of defining what kind of securities to buy can almost be thought of as the process of developing a personal style of investing. Some investors have a knack for discovering the next great growth stock. Others are better at evaluating distressed assets. Still others may prefer “great businesses at good prices” or “cigar butts” as the way to success. There is no single way to value investing heaven. One of the best pieces of advice I ever received when I started my career was very simple but profound: “Learn what types of ideas work best in your hands.” Nevertheless, improving these four decision points will help any investor refine the style that works for them.

Once you’ve found a security on your “wish list” the next step is to determine what price to pay for that security that allows you to achieve your specific investment goal. For value investors, this decision almost always involves an effort at determining the “fair value” of a security and then applying an appropriate discount to that value. Note that once you’ve established a price you’d be willing to pay, you don’t always have control over whether the market will offer you the shares at that price (unless, of course, the stock is already there). For value investors a big key to success is having the patience to wait until Mr. Market offers you the “perfect pitch” before swinging the money bat.

The third decision is to determine how much of his or her available capital to allocate to the idea. Again, making this decision first requires that the investor have a mental model of what kind of portfolio he or she wishes to manage. Is it one hundred stocks, ten stocks, or something in between? Are all new investments given the same default weighting, or is each idea sized differently on a case-by-case decision? As you can probably see, any real attempts to improve the position size component of the decision cycle both promotes and requires clarity of thought about portfolio construction as well.

Finally, there is the sell decision. Obviously every investor hopes to sell each stock he owns at a higher price than what he paid for it. This implies that some effort must be put into determining what price would compel the investor to sell some or all of the position. For value investors, this decision is usually based partially on valuation and partially on the availability of other compelling investments. The sell decision is made much easier if there was quality analysis put in at the time of the original purchase decision.

## The Centaur Process

From the beginning, one of the fundamental aspects of managing and improving the investing process at Centaur Capital has been to maintain written research on each idea from the buy decision all the way through the sell decision. I've found that writing down the reasons for our decisions – why this stock, why this price, why this position size – forces a clarity of thought and can be helpful in avoiding impulsive decisions. It also gives us a huge head-start on making a good decision on the sell side of the process.

What we've discovered is that getting the first two decision factors right – what stock, what price -- is about 90% of the battle. Most of the time when we get this part of the decision cycle wrong, it is because we bought a stock we shouldn't have bought. When we make a mistake, usually paying a price 5-10% lower than we did wouldn't have helped much. The sizing decision will never be perfect – every winning investment should have been a bigger position, every loser should have not been bought at all. Position sizing is all about trying to get as much out of every good outcome as we can, while minimizing the damage of the bad outcomes.

In between the “buy” and “sell” decisions, there is the process of keeping up with the stock, and making the series of decisions to maintain, add to, or reduce one's investment. We've come to believe that this a critical part of the decision cycle, and we spend a lot of effort to get it right. This is because adding to an existing position as new conviction is gained or as the stock price declines can make a big difference when that idea eventually works out. Similarly, reducing the position as the stock gets closer to fair value or as conviction in the idea declines can help protect the portfolio from capital loss. Basically, our goal is to review any material new information as it becomes available on our portfolio companies – usually, this would be the annual and quarterly financial reports as well as other significant events that could impact our assessment of the idea.

On the sell decision, we generally already know what price we're holding out for on each of our portfolio investments – this is the benefit of having the written research. The key, however, is actually making the sale when Mr. Market gives you your price. For whatever reason, we sometimes find ourselves reluctant to let our position go when the stock price reflects our fair value estimate. Once we've sold a stock, we make a final analysis to determine whether there would be some price at which we would consider buying it back, which brings us back to step one of the cycle. We have occasionally been able to take advantage of an opportunity to buy the same stock again at an undervalued price and repeat the process.

While we have occasionally experienced bad outcomes despite making quality decisions, usually when we get a bad outcome we are able to peg it to a breakdown at some point in the decision cycle. Often the breakdown is simply

lack of discipline, lack of patience, or a decision rooted in emotion or impulse rather than one that relies on the good research we've produced. The benefit of being able to pinpoint the breakdown in the decision cycle is that it provides an opportunity to identify one's specific weaknesses and to develop a strategy to making better decisions over time. This process of learning "what ideas work in your hands" is the essence of the evolution of a value investor.