FocusInvestor.com: The Focused Few Presents:

The Focus Investing Series Part 1: Introduction

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Introduction

What is focus investing? Focus investing is a process that approaches investing in equities from the perspective of a business owner. The focus investing process also involves maintaining a concentrated portfolio of businesses that the investor believes has a high probability of outperforming the market over an extended period of time.

Practicing focused investing is not for everyone. If you don't have the time or the interest or aren't willing to work hard at it then purchasing a market index fund would be the recommended course of action. If you believe in the investment style but would rather purchase a mutual fund managed by practitioners of the focus investing discipline I have listed several of the practitioners I believe follow the approach on the FocusInvestor.com Internet site.

This article only attempts to provide an introduction to focus investing. A more in-depth discussion of the subjects discussed in this article will be forthcoming in a book I am currently writing.

I would like to thank several people for their help in making this project a reality. My wife was very supportive of the effort and for that I am indeed grateful. The writings of Warren Buffett, Benjamin Graham, Charlie Munger, and Philip Fisher heavily influenced my investment opinions and I wanted to thank them for taking the time to help educate generations of investors.

I also wish to thank all the people who helped make this series of articles a reality. Without their probing suggestions and comments this article would not be an effective tool for the focus investor.

Chapter One: First Things First

A defining event occurs before most investors dip their toes into the common equity investment market. They may have decided to start planning for their retirement or they may have been caught up in the wave of stock market euphoria that occurred during the 1990s.

Potential investors should closely examine their financial situation before they begin investing in the market. No investor should commit any money towards an investment until they have determined that no short-term situation can occur that will force them to end a particular investment at an inappropriate time. Investors should never put themselves into the position where short-term issues control their investment decisions.

New investors should create an emergency fund which should be sufficient to allow them to live for at least six months before they have to resort to using their long-term savings.

New investors should also ensure that all credit card and high interest rate debt has been paid off in full before any investment program is initiated. Credit card and high interest rate debt is the most cunning adversary to securing any type of financial independence. Here is an example of just how insidious credit cards can be. If you have a credit card that charges you an 18 percent interest rate with a balance of $2,000 and you only make the minimum $40 required monthly payment it will take you almost eight years to pay the $2,000 (assuming you never make another charge and the credit card has no annual fees).

Here is another example of the costs involved in not paying off high interest rate debt. For instance, let's imagine that you had a total minimum payment of $218 a month on your credit cards. If you were able to invest that money instead and earn a 12 percent compounded return you could retire in 25 years with approximately $1.3 million in the bank! Credit cards not only cost you thousands in unnecessary interest costs but also prohibit you from attaining your investment goals.

The following link will bring you to a site that has a number of great calculators available that can assist you in examining your financial status. The hyperlink to the site is:

http://www.financenter.com/consumer/calculators/

Chapter 2: Initial Preparation

To become a successful investor requires preliminary study of several areas. We will start this section with a brief lesson on the history of investing, for much can be learned of the future by closely studying the past.

The book I recommend that investors read first is a book entitled *Devil Take the Hindmost: A History of Financial Speculation* by Edward Chancellor. Reading this book and the introduction to the classic investment book, *Security Analysis* by Benjamin Graham and David Dodd, will provide the investor with much needed insight into the history and psychology of the market. It is vital for the new investor to understand that waves of optimism and greed can drive the price of the overall market high above any reasonable estimate of its true value and waves of fear and despair can drive the market below reasonable estimates of fair value.

Perhaps the best and certainly among the most famous discussions concerning how investors should view the market comes in Chapter 8, The Investor and Market Fluctuations, of *The Intelligent Investor: A Book of Practical Counsel* by Benjamin Graham. Mr. Graham was essentially trying to tell investors reading his book that they should think of the market as providing them with "…the opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention …to the operating results of his companies."[1]

Mr. Buffett also spoke about what you need to know as an investor in his 1993 annual letter to Berkshire Hathaway shareholders. He stated: "Investing is not complicated. You need to know accounting, the language of business. You should read *The Intelligent Investor.* You need the right mindset, the right temperament. You should be interested in the process and be in your circle of competence… Avoid over stimulation. Read Ben Graham and Phil Fisher, read annual reports and trade reports, but don't do equations with Greek letters in them."

Mr. Buffett brings up another vital area for new investors to study. They must develop an understanding of the accounting process. Any college course should be able to teach the accounting basics. Investors can also educate themselves by studying another book by Benjamin Graham and Spencer Meredith entitled *The Interpretation of Financial Statements*. This book has been published in several editions (with the latest being published in 1964) and should start the new investor on the right path to a sound understanding of basic accounting concepts.

The letters to shareholders section in Berkshire Hathaway's annual reports, written by Mr. Buffett, is also a great source of information regarding the investment process and how it should be practiced. Mr. Buffett is a truly gifted writer and is able to explain his ideas in a very concise and easy to understand manner. All new investors should closely study his writings. The Berkshire letters to shareholders can be viewed at Berkshire's website (http://www.berkshirehathaway.com) or can be ordered in a three-volume set which contains the entire collection of letters Mr. Buffett has written from 1977 to the present. The cost for the set is $35.

[1] Page 109, The Intelligent Investor (4th Edition) by Benjamin Graham

Chapter 3: Key Concepts

New investors need to understand several important concepts before beginning to make investment selections. They should understand compound interest, the time value of money, the effects of inflation, the margin of safety concept, and market psychology.

Simple and Compound Interest

The scientist who developed the theory of relativity, Albert Einstein, is alleged to have called compound interest one of the universe's most powerful forces. It is truly amazing how small sums can grow into large sums over time as interest is regularly added to the principal. As a first step towards understanding the compound interest concept the investor should understand the difference between compound and simple interest.

Simple interest is calculated only on your initial investment outlay (i.e. the principal). For instance, if you were to receive a 5 percent interest rate on $10,000 deposited into a savings account after the first year you would have received $500 in interest payments. The $500 in interest being paid is to compensate the depositor for allowing the bank to use the $10,000. If you continued to receive a 5 percent interest payment on your principal each year the growth in your original principal over five years would be:

Chart 1: Effects of a Simple Interest on an Initial Deposit	
Year 1:	$10,500
Year 2:	$11,000
Year 3:	$11,500
Year 4:	$12,000
Year 5:	$12,500

Although you have earned interest payments for letting the bank use your deposits these are not the kind of returns investors should be striving to achieve over the long term. That is why investors desire to have their interest payments paid on a compounding basis.

Compound interest takes into account the amount of interest your money has earned and adds that interest to your initial principal on a recurring periodic basis. As a result, the initial investment grows at a much more satisfactory rate in comparison to the simple interest rate growth in the example previously mentioned. Here is an example of the difference between what an investor would expect to earn using a monthly vs. yearly compounding rate using the same parameters as the simple interest rate chart.

Chart 2: Effects of Compound Interest on an Initial Deposit			
Yearly Compounding		**Monthly Compounding**	
Year 1:	$10,500	Year 1:	$10,512
Year 2:	$11,025	Year 2:	$11,049
Year 3:	$11,576	Year 3:	$11,615
Year 4:	$12,155	Year 4:	$12,209
Year 5:	$12,763	Year 5:	$12,834

As you can see by observing the difference in ending balances, the more frequent the compounding period the better it is for investors. Although the differences appear minor in these examples, the longer the compounding period is and the higher the interest rate earned is the more dramatic the effect will be on the investor's ending account balance.

A simple way to calculate how long it will take to double your money when earning a known compound rate of return is to use the Rule of 72. To use this rule the investor simply divides 72 by the interest rate the investors are earning on their accounts. For example, at a 6 percent compounded rate of return the investors will double their investment's value every twelve years (72 divided by six).

This chart shows how long it will take for varying rates of return to double your investment:

Chart 3: The Rule of 72	
Rate of Return Earned:	Investment will Double Every:
3%	24.0 Years
5%	14.4 Years
7%	10.3 Years
10%	7.2 Years
12%	6.0 Years
15%	4.8 Years
20%	3.6 Years

Time Value of Money

The time value of money reflects the fact that money received in the future is worth less than money currently in your possession. This is true since investors could spend the money today and thus not have to worry about inflation risk decreasing their actual buying power. In addition there is always the risk that they will experience a loss of principal or that a better opportunity might appear in the future.

This is such an important concept because one of the primary means for an investor to determine the value of a business is to discount all of the future cash flows that the investor believes the company being examined will generate over its life span.

When calculating the present value of a company's future free cash flows it is important that you use an appropriate discount rate. Mr. Buffett has previously stated that he uses the current rate of the 30-year U.S. Treasury bond.

Present Value Example:

Assume the company being examined has an annual cash flow of $100,000 and the cash flow is expected to remain at this level. To determine an approximate intrinsic value of the company using the discounted cash flow method you would perform these calculations. In this example a 10 percent discount rate is assumed.

Chart 4: Example of a Present Value Calculation			
Year	Free Cash Flow	Divided by	Present Value
1	$100,000	1.10	$90,909.09
2	$100,000	$(1.10)^2$	$82,644.63
3	$100,000	$(1.10)^3$	$75,131.48
4	$100,000	$(1.10)^4$	$68,301.35
5	$100,000	$(1.10)^5$	$62,092.13
Totals:	$500,000		$379,078.68

So the intrinsic value of this company (considering only five years of results) would be approximately $379,078.68. If this was a public company the investor could then divide this number by the number of shares outstanding to determine an approximate per share intrinsic value.

The following link to the FocusInvestor.com Discounted Cash Flow Calculator page explains the process in more detail and allows investors to calculate the estimated intrinsic value of the company they are examining using their own assumptions. They can also run several different scenarios (i.e. assume a higher/lower growth rate for example) so a range of intrinsic values can be determined.

http://www.focusinvestor.com/scripts.html

Inflation

At an average annual growth rate of 10.9 percent a year, an investment should double your money every six and a half years. When inflation is considered, which has historically run at about 3.7 percent annually; it will take close to 10 years to double your actual buying power. If an investor had invested in a money market account earning a 2-3 percent yield the investor would actually lose actual buying power if inflation continued at the historical rate of 3.7 percent.

This raises a key point to consider concerning inflation. Investors need to understand the difference between "nominal" changes in money (meaning physical dollars) and "real" changes (meaning purchasing power) and the effect inflation has on them. For instance, consider a certificate of deposit (CD) at a bank that is paying you 7 percent over a 12-month period. The nominal return, assuming an inflation rate of 3 percent, would be 7 percent, while your real rate of return would only be 4 percent. This 4 percent return is due to the cost of goods increasing by the rate of inflation.

Despite short-term corrections, wars, recessions, global upheavals and economic downswings, historically the equity markets have outperformed more conservative investment choices, as well as inflation. Keep in mind, of course, that past performance is no guarantee that future results will be the same as those experienced in the past.

Margin of Safety

The concept of investing with a margin of safety is one of the most important investing concepts. In his book, *The Intelligent Investor*, Benjamin Graham stated that if he had to "distill the secret of sound investing into three words, we venture the motto, MARGIN OF SAFETY."[2]

[2] page 277, The Intelligent Investor by Benjamin Graham

Investors practice the margin of safety concept when they purchase securities at such an attractive price that the business doesn't have to perform perfectly for the investor to still achieve a satisfactory rate of return. Mr. Graham further elaborated on this point when he wrote in The Intelligent Investor that "the margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, nonexistent at some still higher price."

Market Psychology

The focus investor needs to understand that although the market is fairly efficient it is certainly not efficient at all times and that investing should be conducted in a businesslike manner. They should form and trust their own opinions of the situation after a close examination of the facts concerning the situation.

Individual focus investors can outperform the market if they understand that other investors fall prey to severe mood swings. The market as a whole can be very optimistic on the growth and profit expectations of certain industries and individual companies. The market can also be extremely pessimistic. The focus investor needs to avoid the noise of the market overall and focus on finding good companies selling at attractive prices.

The so-called professional investors also have an extremely short-term focus that focus investors can take advantage of by investing in companies that experience short-term problems that in no way affect their long-term competitive advantages.

Chapter 4: How to Become a Focus Investor

The first areas a focus investor should understand completely have already been discussed: the history of the market and a good working knowledge of accounting. The next step for the focus investor should consist of reading several of the classic investment texts already discussed earlier in this article.

When the investor is ready to start investing in individual companies they first should study companies that are involved in a business they understand. Mr. Buffett advises investors to study companies that fall within their "circle of competence". For example, the focus investor may want to start examining companies that are involved in the industry that they currently work in.

The investor should order several previous annual reports for any company that they are interested in and also the annual reports of that company's competitors. The investor should also study any trade publications that may cover the industry being examined. This information should enable the investor to determine which company in the industry has the best competitive position and the letters to shareholder section should enable the investor to gauge how in tune management is to the interests of its shareholders.

The investor should be looking for companies that have some type of sustainable competitive advantages. For instance, some companies have a low cost structure (i.e. GEICO) that enables them to consistently earn higher returns than their competitors, while others may have an established brand name and distribution system (i.e. Coca-Cola).

Several additional sources of quality information for the investor are publications such as Value Line (http://www.valueline.com), which provides the investor with a rich source of historical information on over a thousand companies. Companies are also required to file certain forms with the SEC (such as a 10K which resembles a company's annual report but contains additional useful information). This information can be found at sites such as Edgar Online (http://www.edgar-online.com) and on the websites of individual companies.

Chapter 5: Diversification & Portfolio Turnover

This chapter will examine two investing issues that separate the true focus investor from the majority of the investment community: diversification and portfolio turnover

Diversification

Before a focus investor starts to construct a portfolio they should understand the concept of diversification. The Modern Portfolio Theory (MPT) teaches that the broader the diversification of an investor's portfolio the lower the systematic risk (systematic risk is the risk of the market as a whole declining in value) will be. The MPT also teaches investors that with a perfectly diversified portfolio all unsystematic risk will be eliminated.

Diversification is a great concept for an investor to understand but like almost everything else in life it is not a good thing when carried to extremes. Focus investors should be able to acquire adequate diversification and still have a limited number of companies in their portfolios, thus reducing company-specific risk (i.e. systemic risk which is measured by Beta in MPT) to an acceptable level. There is no way to eliminate market risk via diversification no matter how extreme the amount of diversification practiced.

Risk is measured under MPT by a concept called standard deviation. Standard deviation measures how much more volatile the investment returns of a specific stock are when compared to the overall stock market. I do not believe that is an appropriate measure of risk for any rational long-term investor. Instead long-term investors view this volatility as providing opportunities to purchase more of a good business at attractive prices when prices decline.

Risk to a focus investor consists of the risk that their investment returns won't be greater than the investment returns of the overall equity market. They also view opportunity cost and principal loss as investing risks. For example, they may have invested in a company that didn't provide the expected returns when they could have invested in a company that returned far more than the markets.

This quote by Warren Buffett concerning portfolio concentration echoes my own thoughts: "We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he must feel with its economic characteristics before buying into it."[3]

The process of concentrating your investment selections as a form of diversification is the exact opposite of what the investment community teaches. Focus investors must be able to think for themselves and have the fortitude to remain steadfast in their convictions.

Portfolio Turnover

Portfolio turnover is a very important issue for the focus investor to understand since it can directly affect your investment returns. Excessive trading in an investor's portfolio results in the investor realizing short and long-term capital gains (outside of a retirement account of course). These taxes lower overall investment returns, as do the commissions that must be paid. When examining mutual funds the tax issue is especially important. John Bogle, in an article entitled *Equity Fund Selection: The Needle or the Haystack?* advised that according to his calculations the

[3] 1993 Berkshire Hathaway Annual Report

effect of taxes (generated from the selling of positions) approximately doubled the cost of owning a mutual fund between 1984 and 1999. This is especially telling since the funds themselves pass this expense onto their shareholders.

A high degree of portfolio turnover also presents a challenge of another sort to the investor. Every sale means that the investor must conduct research to find another company with sustainable competitive advantages. If that isn't challenging enough, investors must also make sure they find the company when its price offers a sufficient margin of safety. When an investor finds a company that has a sustainable competitive advantage selling for a great price, and it is continuously growing the economic moat around its business, why should the investor sell it unless its price is grossly out of line with its intrinsic value?

Warren Buffett expresses his ideas on the subject of portfolio concentration and portfolio turnover extremely well in the following quote:

"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. 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."[4]

Philip Fisher, another investor whose books all focus investors should study closely, also has some very pertinent words to say on these subjects in the following quote:

"The percentage of investors who own 25 or more different stocks is appalling. It is not this number of 25 or more which in itself is appalling. Rather it is that in the great majority of instances only a small percentage of such holdings is in attractive stocks about which the investor has a high degree of knowledge. Investors have been so oversold on diversification that having too many eggs in one basket has caused them to put far too little into companies they thoroughly know and far too much in others about which they know nothing at all. It never seems to occur to them that buying a company without sufficient knowledge of it may be even more dangerous than having inadequate diversification."[5]

In conclusion, don't be trapped by what you have been taught about diversification and risk. Be the master of your own investment decisions, stay in your circle of competence, and be confident in your conclusions. And last, but not least, when the perfect pitch approaches, hit it out of the proverbial ballpark! Please feel free to visit the FocusInvestor.com message board at http://www.focusinvestor.com/cgi-bin/forum/ikonboard.cgi to discuss any topics in this article or email me at rich@focusinvestor.com.

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[4] 1996 Berkshire Hathaway Annual Report
[5] page 108-109 Common Stocks and Uncommon Profits by Philip A. Fisher

Appendix: FocusInvestor.com Investment Principles

I.	**Develop a comfortable understanding of the language and concepts of investing**
-	Study a basic accounting book like The Interpretation of Financial Statements by Benjamin Graham
-	Understand how four concepts, Compound Interest, Present/Future Value, Inflation, and the difference between price and value affect your investing results
-	Learn how cash flows through an company
-	Learn how companies manage their inventory
-	Keep a close eye on how fast inventory and accounts receivables are growing. They should not be growing faster than the business's overall sales growth rate
II.	**Purchase High-Quality Companies below Intrinsic Value**
-	Look for companies selling below intrinsic value (Use a Margin of Safety)
-	Look for a trustworthy, shareholder-oriented, high-quality management team
-	Ensure the business has sustainable competitive advantages
-	Ensure management makes rational capital allocation decisions
III.	**Portfolio Concentration**
-	10 to 12 stocks allows adequate diversification against company specific risk
-	Over-diversified portfolios will tend to track the performance of the overall stock market
-	Make large, concentrated purchases when the perfect opportunity presents itself
IV.	**Minimize Portfolio Turnover**
-	Minimizing portfolio turnover will keep commissions and taxes paid at a minimum
V.	**Understand the Psychology of Investing**
-	Understand how market and stock volatility will affect investment decisions
-	Patience and intestinal fortitude are requirements when investing
-	Stand by your convictions
-	Understand how rules of thumb can affect investment decisions
-	Understand and practice the concept of delayed gratification
VI.	**Build a Latticework of Models**
-	Develop a framework of "mental models" from various disciplines to gain better understanding of the investment process
-	Be able to combine multiple models when making investment decisions

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