CANNELL & SPEARS

April 10, 2024

How We Think About Stocks

Clients sometime ask why we don't own a particular stock; usually the stock in question is a highflyer that has been in the news and just made an enormous move in price. Or they might ask if we are considering the purchase of a fallen angel, a revered company that the market believes has lost its way.

To answer, it is important to note that a "good company" does not always make for a "good stock" just as a "bad stock" does not always make for a "bad company". It is really a discussion of Price vs Value.

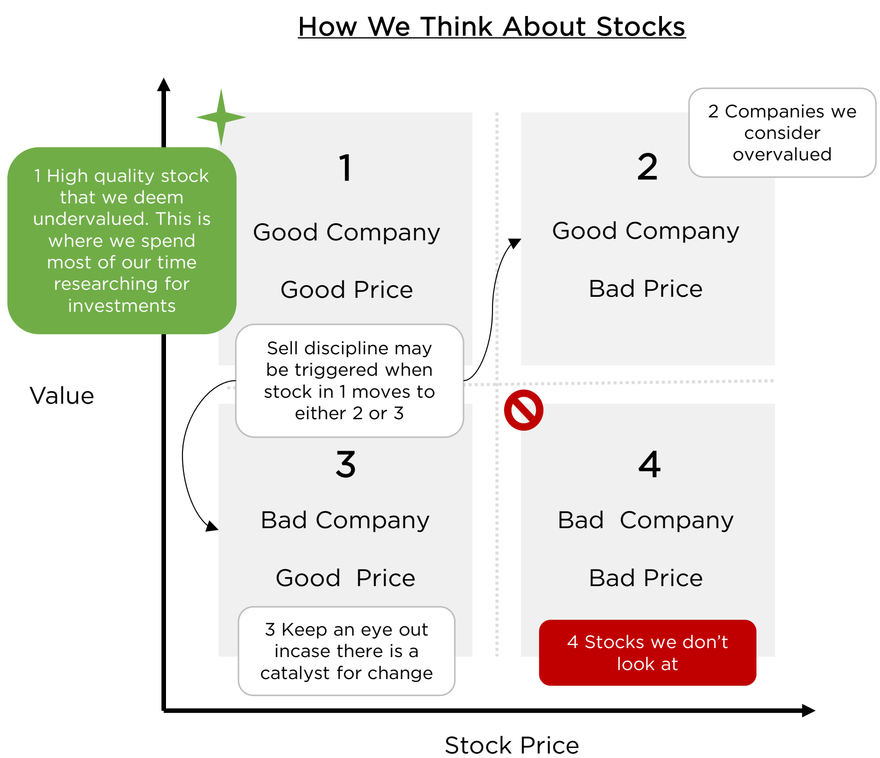
The PRICE of a stock can fluctuate wildly in a given year based on a multitude of factors, with little or no change in the underlying VALUE of the business. For example, in 2023 the S&P 500 Index advanced 26% while the average stock fluctuated 69% in price that year - a truly amazing statistic[1]. Often investors mistakenly focus on price alone (ignoring value) when making investment decisions, drawn in by momentum and FOMO.

Buffett says… "If you don't know how to value a business, you don't know how to value a stock. In order to properly evaluate an investment, one must have a handle on what a company is worth and then compare that to the current share price. That's what investing is. And I don't know any other kind of investing to do."

As analysts we are constantly comparing price to value. Our assessment of value is what drives the investment process. Figuring out what a company is worth (and what it could be worth in the future) is a complicated process. There are many variables to consider (or as importantly ignore) when assigning value to a business. It is not a precise science that some would have you believe. The discovery of an undervalued company is like solving a puzzle before others, then watching as the ascribed value becomes reflected in the share price.

It should be clear that price and value are two very different things…and it is the disconnect between PRICE and VALUE that creates investment opportunity.

Consider the chart to the right. We are value-oriented



[1] Source: Bloomberg

investors searching for high quality companies that are undervalued. As such, much of our time is spent searching for investments in Quadrant 1.

Quadrant 2 represents high quality companies that trade at full valuations (or are overvalued). We spend time searching here, but there is less opportunity given that these companies for the most part are discovered with valuations that reflect this. It is our hope that our Quadrant 1 companies would over time migrate into Quadrant 2, thus achieve a higher valuation that better reflects their underlying value.

Less of our time is spent in Quadrant 3 given our desire to hold high quality companies. Though we are sometimes drawn to Quadrant 3 companies when there is a catalyst for change. It could be as simple as a change in management, the introduction of a breakthrough product, an accretive acquisition, or even activist involvement seeking to upset the status quo. These factors have the potential to improve the business and move it into Quadrant 1, making for a very interesting investment.

It goes without saying that we try to avoid Quadrant 4 companies at all costs.

As a rule we want to invest in businesses that build value over time. We seek high quality, growth-oriented companies and hope to hold them indefinitely. We look for strong management teams who allocate capital responsibly. We want free cash flow generative businesses with low leverage and high ROIC. We want to see a sustainable competitive advantage in the business and strong pricing power.   These attributes (among others) are what define a high quality company.