

# THE ART OF INVESTING

*A Conversation with Roger E. King*

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Since the inception of King Investment Advisors in 1981, we have been writing our quarterly publication, the *DecisionMaker*, and have usually chosen a topic which is a reflection of the current macroeconomic scene. Although the economy and the markets are in a state of perpetual change, in the final analysis, certain constants remain. Woven through the history of the *DecisionMaker* are common themes based on our fundamental investment philosophy. We trust friends,

both old and new, will enjoy and benefit from this conversation piece, which explores these common themes that have been guiding our investment process since 1981.

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## *What is your investment philosophy?*

We call it the Business Valuation Approach. We are a value manager, but one who is willing to buy growth at the right price. We identify attractive investment opportunities using a broad definition of value, uncovering securities often overlooked by other investors. We believe value can be found in different types of securities at different points in the economic cycle.

Most consultants who hire money managers for their clients want to pigeonhole us in different style boxes (for example, small-cap, mid-cap, growth, and so on). We certainly have a distinctive style, but we resist narrow categorization. Our approach results in finding bargains among a wide variety of companies large and small, growth and value. Our primary focus is on

the company's worth as a business, and whether the public price reflects that worth. To those who say that a value manager should never buy growth, we counter, "Would you prefer we buy non-growth?" Everyone wants growth; they just may not be willing to admit it. The secret of success is to buy at an inexpensive price.

We use a "bottom-up" stock selection process based on fundamental financial analysis, focusing on individual companies rather than using a broad macroeconomic, top-down approach. The latter attempts to identify industry groups and stocks based on an overall economic outlook. We do not place much confidence in the accuracy of broad economic forecasts. Ask five economists for their outlooks, and you get ten opinions.

## *What are the three disciplines?*

**The Business Valuation Approach** comprises three distinct disciplines: private-market valuation, historical valuation, and superior earnings growth. A company in which we invest will meet at least one of these three criteria.

➤ **Private-Market Value** can be calculated in one of two ways. One is what the company will be worth if liquidated, although this rarely happens. The other is what the company might be worth if acquired in an all-cash or arm's-length-negotiated transaction. Thus, we value the company as a going concern. We ask one basic question: would we be willing to buy the entire company at the current market price? Ideally, we are willing to buy a stock if it is trading at a discount to its private-market value.

➤ **Historical Valuation** focuses on identifying stocks selling at the lower end of their fundamental benchmarks, like price/cash flow, price/earnings, price/book value, and price/sales. Stocks selling at the low end of their multiple ranges may often prove to be potential purchase candidates.

Regarding our historical valuation approach, it is significant that the methodology used by most value managers limits them to buying only low-multiple stocks. However, we think value managers who focus primarily on this measure of value needlessly exclude opportunities using private-market value or growth at a reduced price—both of which can often provide great values.

➤ **Superior Earnings Growth** means buying growth at a reduced price (GARP), so indeed it does fit in quite well with our value philosophy. The simplest measure would be to unearth stocks whose P/E ratio is well below their expected five-year EPS growth rate. Our fundamental research for GARP stocks includes many of the same measures and factors just described for the low historical valuation approach, but with more emphasis on such factors as a

company's competition, the impact of technology, franchise value, the company's position in its markets, and demographic trends. As far as our willingness to buy growth, I have never met a value manager who did not really care about earnings growth.

We research prospective stock purchases extensively, and we emphasize fundamental analysis for all three disciplines, as well as other factors such as insider buying or ownership and hidden balance-sheet assets. That a company is a potential takeover candidate is an added plus for a stock which we would buy primarily on the basis of either historical value or growth at a reduced price.

## *Your clients have benefited from takeovers and mergers. To what do you attribute such good luck?*

As they say, it is better to be lucky than smart. However, in the investment business, you make your own luck. This is a highly competitive industry in which only a handful of managers outperform their benchmarks over long time periods.

But takeovers are hardly a recent development for our clients; they are a by-product of our investment process. Takeovers have characterized our firm since its inception. In fact, we are rarely surprised when one of our holdings is bought by another company at a premium above the market, because we buy companies valued at fifty cents on the dollar. It is only logical that if you buy companies at public prices below their enterprise value, others may eventually recognize this value as well. When the public stock price of a corporation is at a significant discount to its private-market value it will not remain on the bargain counter forever. Any number of catalysts will cause the stock price to increase, in some cases dramatically. This focus on private-market value has contributed to our success over long periods through different types of markets. It is also what sets us apart from most managers.

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### *How do you decide when to sell, and what is your typical holding period?*

We hold 30 to 35 stocks in the portfolios and we monitor all of our investments very closely. Our primary reasons for selling a stock are: price objectives are met and further upside is limited, there is a change in the company's fundamentals, or more attractive alternatives are found. Our holding period is typically one to three years.

We also watch the stock's relative price performance. While our sell discipline is always driven by fundamentals, if a stock begins to significantly underperform the major indices, it will be flagged and may become a candidate for sale.

### *What traits characterize a successful money manager?*

That question has no perfect answer, and any answer will reflect certain professional biases, but I will take a stab at it. Among the essentials are a keen intellect, a natural curiosity, and a healthy skepticism. Good analysts and money managers are certainly born with talent, but it takes twelve to fifteen years to become a truly good money manager. Many intelligent people simply do not have the knack for making good investments. Perhaps even more important than intelligence is a willingness to be a contrarian and swim against the tide of conventional wisdom. A truly successful money manager must have intestinal fortitude (i.e., guts) leavened with a great degree of humility born out of experience and wisdom. Numerous studies have demonstrated that most investors' aversion to loss is greater than their desire for gain. Such a mindset results in the tendency for investors to do what is (in their minds) seemingly safe, or to invest in that with which they are comfortable. Invariably, this proclivity results in foregone opportunities and below-average long-term investment payoffs.

You do not have to take foolish risks to achieve good investment returns, but you do need to recognize opportunity where others do not, and equally important, seize the opportunity through action. How many times have we heard the familiar, "I can't believe I didn't realize how much things had changed?" Or more pointedly, as it relates to frustrated investors, we have empathy for the remorse expressed in, "I can't believe I didn't buy (or sell) that stock. I just knew I was right."

Most investors fail to recognize investment value because their frame of reference requires a near-perfect convergence of the ideal circumstances for economic success, and they are uncomfortable with standing alone against the tide of conventional wisdom. Accompanying the desire for perfection and the propensity to be comfortable with consensus thinking is the fear of losing. However, in the real world, the ideal set of circumstances and a good price rarely converge.

Thus, an outstanding money manager is intuitive as well as thoroughly grounded in basic security analysis conducted within a framework of a solid understanding of economic rates of return. With regard to the intuitive and qualitative aspects, you should almost view the world upside down. Far too many security analysts and investors make their decisions as if they were looking in a rearview mirror to predict the future. Admittedly, historical analysis is key to developing a framework for evaluating the absolute and relative value of investments. However, more often than not, when recent poor economic or bad corporate news has affected a company, the stock price already reflects most of the known negatives. Likewise, when recent corporate news has been positive, in most cases the stocks of affected companies reflect the attendant high levels of confidence, comfort, and complacency.

A money manager, as opposed to the sometimes narrowly focused securities analyst, must have the insight to recognize a good (and hopefully great)

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investment from among the thousands of choices available. One of the keys to investment success is the ability to grasp the potential impact on stock prices of two types of changes: a change in operating fundamentals and a change in the perception which investors have of a particular investment. Savvy investors conceptualize the impact of these changes earlier than most. And, although seemingly swimming upstream at the time, the successful investor is more willing to buy when others are selling, and to sell when others are buying.

Another asset is patience. It takes time for fundamentals and perceptions to change. The patient investor, acting out of conviction, will allow events to unfold. If he has purchased intrinsic value at a significantly discounted price, he is less apt to worry about “the market” and its incessant ups and downs. The impatient, convictionless seller or buyer, vainly attempting to time the market, can be a value investor’s best friend.

### *Are there other intangibles you look for in a money management firm?*

Another trait of successful money managers is their passion. They must be possessed of a passion to excel. The investment world is populated with thousands of very bright people, and those who excel seem almost consumed with the desire to win. They relentlessly devour information. Their adrenaline surges when they find another great investment. They are galvanized by the challenge to win in a business in which victory can be measured daily, weekly, monthly, yearly, and longer. And they are certainly not complacent but vigilant, aware of the daily potential for both disaster and success. Sure, good money managers are motivated by money, but most are equally (or even more strongly) motivated by the sheer challenge of the game. Numerous outstanding managers make and possess huge sums of money personally, but they continue the race simply because they love it.

### *So, do great managers care more for the race or for their clients?*

In addition to the passion for investment success is an equally important passion which marks outstanding money managers: a passion for bringing wealth to their clients. In the investment industry, client success, while sought after, is often subordinate to industry success or asset growth. Without exception, managers who hold client interests paramount will, in the long run, stand a better chance of achieving success as measured by investment returns than organizations which revere asset growth as the barometer of success. Certainly, size and a satisfied clientele are not mutually exclusive, and organizational strength and resources can be important ingredients of successful firms. But a super-charged marketing operation whose primary (if unstated) goal is asset growth is less likely to excel from an investment standpoint than the organization for which client success is the benchmark for achievement.

Morningstar, Inc., which is an independent research firm that compiles and analyzes money managers, has made some salient observations on firm size and marketing strategy. In reviewing some successful and “forgotten” money managers, Morningstar stated:

*... small asset bases can be especially advantageous for [managers] that pursue flexible strategies... or those that focus on less-liquid securities, such as small-caps or convertible... These [managers] have the added advantage of being run by small shops. Such firms seem less marketing-oriented and more investment-driven than big... companies. Moreover, their managers tend to be principals in the firms— a factor in their lengthy tenures— and to have significant ownership stakes, which ties their interests more closely to those of [clients]. Thus, our forgotten [managers] not only demonstrate that quality doesn't have to come in big recognizable packages, but that small can sometimes also be an intrinsic advantage.*

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Undoubtedly, we cannot be accused of being a marketing powerhouse, but we hope our long-term record makes us huge in the eyes of our clients.

A corollary to a passion for client success is a manager's willingness to eat his own cooking. It never ceases to amaze us how often professional money managers are willing to invest in securities in which they would not put their own money given comparable investment objectives. Frankly, we like to buy what our clients own— although our code of ethics precludes us from buying or selling before our clients' interests are served. We want all of our clients to benefit from our passion. We also manage our own company-funded profit-sharing trust which owns a large number of the equity securities held by our clients. This alignment of our interests with those of our clients, while not unique in the investment world, helps us in feeling both their joy and their pain.

### *Why do you occasionally make a wrong turn?*

It is always interesting to have client meetings in which a good part of the discussion centers on the "losers." While a good manager hates to lose, it is important not to brood, agonize, or consider it a personal failure. A good manager learns from the experience of the loss, and moves on.

Superior managers who have outstanding long-term records have usually hit a few bumps along the road, and have made investments which did not pan out. Ironically, this is a sign of good management. Aside from the fact that losing investments may be few in number, they signal a willingness to take well-thought-out risks. The more fearful you are to take a considered risk, the less likely you are to make those investments which will become the home runs of a portfolio. In attempting to avoid losing at all costs, you also forego winning. Again, this issue revolves around the psyche of investing. Too much emphasis on playing it safe yields mediocre results. On the other hand, injudicious speculation or "playing the

market" will result in consistently bad decisions with predictably poor returns.

If you cannot stand to incur a loss in individual stock investing, as opposed to recognizing that occasionally a loss is inevitable, then you do not really possess the disposition to invest. And if you are more inclined to be comfortable, then you should be willing to accept average results. Unspectacular decisions usually yield unspectacular results.

### *Is it really possible to achieve outstanding returns without taking inordinate risks?*

Investors often confuse business risk with stock market risk. There is very little business risk with long-established corporations whose finances are strong, whose products and services are in demand, and who have a history of sound management. But investors will often pay too much for historical success and perceived safety while paying too little attention to their market-valuation risk. Value investing, which focuses on the intrinsic (as opposed to market) value of an economic enterprise, is aimed at evaluating business risk and valuation risk.

Investors also tend to confuse volatility with risk. A narrow focus on individual stock price fluctuation and quarter-to-quarter (or year-to-year) variability in portfolio returns can lead investors to conclude that they own risky stocks, or a risky portfolio. Stocks are volatile, but unless you must sell, the inherent volatility of stock prices or of a portfolio's return can be a misleading measure of valuation risk. Investors who focus on business value and the long term know from experience that stock price and portfolio volatility are inevitable, but can present numerous opportunities, and are a questionable barometer of long-term investment risk.

The Business Valuation Approach should yield opportunities regardless of what "the market" is doing. We do not waste much time on market timing or on worrying about the market, because our clients do

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not own the market. In looking at corporate history, industries that have experienced bear markets or their own depressions in the face of a long-term secular upturn in stock prices are the rule, not the exception. Over the last 30 years, disastrous operating environments have plagued (at different times) automobiles, aluminum, forestry, energy, technology, tobacco, insurance, building, and amusement. You can count on both hands the companies which have escaped unscathed in terms of a disappointing and gut-wrenching stock price decline. Yet, correspondingly, out of turmoil opportunity arises. The recent phoenix-like resurrection and restructuring of such industries as banking, cable TV, brokerage, and telecommunications illustrates the benefits of a well-disciplined approach focused on individual stock values.

### *Any final thoughts?*

We look forward to continuing the pursuit of investment success for our clients. We have witnessed many different types of markets. In all, we have found that our Business Valuation Approach has served our clients well, and should continue to do so.

Yet beyond the disciplines of this approach, those ingredients of success which have served us well will be fostered and encouraged: namely, the enlisting and embracing of colleagues who embrace high ethical standards, who are highly intelligent, and who have a passion for their clients and their profession. We

will continue to practice independent thinking based on solid analysis; we will draw judiciously on our collective experience; and we will maintain a healthy skepticism of consensus thinking based on illusory concepts of safety and risk. Finally, we hope we can exercise not only judgement and wisdom born out of years of successful experience, but also a never-ending enthusiasm for positive change and opportunity from that which is new.

### *About KING...*

KING has been in operation since 1981. Our investment professionals are supported by a capable administrative group. We are committed to creating wealth for our clients in the long term.

Since the inception of the firm, we have successfully weathered several investment gales by adhering to a discipline of value investing geared to evaluating ever-changing data and markets.

We eschew "market timing" as theoretical nonsense divorced from the real world of investment decision-making and investing. Cash will accumulate in client portfolios when we do not find stocks that meet our selective criteria.

We are confident that the knowledge, experience, and dedication of our investment team, and the application of a disciplined process, which has worked successfully over long periods of time, will continue to reward our clients in the years to come.

Please visit our website [www.kingadvisors.com](http://www.kingadvisors.com)  
to learn about the firm and the  
comprehensive investment services we offer.



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