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Investors: You're Not Buying Stock, You're Allocating Capital

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Buying a stake in a publicly traded company is deceptively easy. Log into your brokerage account, type in the ticker of the company whose stock you wish to buy, and — voilà! — you own a stake in the enterprise. Many investors don't even refer to companies by their name; they simply invoke the ticker symbol. The ease with which stocks are bought and sold obscures the underlying nature of a stock market transaction and invites bad decision-making. The trick is to avoid thinking of a stock as a readily disposable piece of paper and instead consider that you are buying a percentage of a business whenever you purchase a share of stock. Your purchase makes sense only if you would invest your capital directly in the business at the terms implicit in the market price of the stock.

Your Role in the Stock Market

Your role as an investor may at first glance seem like a trivial issue. After all, every rational investor wants to attain the highest-possible risk-adjusted after-tax return on invested capital. Isn't each investor's role, therefore, to make the most money for him- or herself by buying and selling securities? The answer is no because the question confuses objective (making money) and role.

Most investors, especially those managing small amounts of capital, view their role in the market as insignificant. While it's true that you will probably not move the market, the accompanying "small fish" mindset is one that doesn't lend itself to successful investing. Regardless of the size of your portfolio, you should adopt the mindset of Chief Capital Allocator. Imagine your role as distributing the world's financial capital to activities that will generate the highest return on equity.

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The Buck Stops Here

If you embrace the mindset of Chief Capital Allocator, you'll make better investment decisions. You may have an easier time deciding whether auto firms, for instance, are a good investment because of their large sales and typically low P/E ratio. Instead of simply analyzing GM versus Ford, as Chief Capital Allocator, you will know instinctively that you don't have to invest in the auto industry at all. Perhaps you'll decide to allocate capital to a biotech company and forgo current profits (and the reinvestment of such profits) in expectation of a windfall in the future. Note that as Chief Capital Allocator, your focus should be solely on return on investment and not on ensuring that every sector, no matter how critical to society, receives capital. While funding socially important activities deserves a place in private and public budgets, you should not make sub-optimal investment choices out of a desire to be charitable.

How can the mindset of Chief Capital Allocator help you distinguish between value and price? If you were in charge of allocating capital around the world, you wouldn't be able to rely on the market to bail you out of bad investments. The greater fool theory of someone buying your shares at a higher price breaks down if the buck stops with you. Successful investors believe their return will come from the investee company's return on equity rather than from sales of stock. This mindset produces a very different process of estimating value than if you rely on the market to establish value and then try to gauge whether a company was likely to beat or miss consensus earnings estimates.

Acting as Chief Capital Allocator requires tremendous discipline, as you may at times receive tips or tidbits of information that give you an edge in a particular stock. If you believe a company may beat consensus estimates, you may be tempted to buy the stock even if the beat would still leave the stock wildly overvalued. Self-restraint is crucial in such situations - you simply don't know how an overvalued stock will react to an apparent earnings beat. Jeremy Grantham, one of the most respected and experienced practitioners of global asset allocation, agrees that investors have a hard time restraining themselves from playing the market: "Most professionals, including many of the best, prefer to engage in Keynes's 'beauty contest', trying to guess what other investors will think in the future and 'beating them to the draw' rather than behaving like effective components of an efficient market; spending their time and talent seeking long-term values." A money manager volunteered his outlook for energy investing to *The Wall Street Journal* in October 2005: "I think the sector is probably a little overvalued, but I wouldn't be surprised to see a run for energy stocks as we get to year-end... People who are behind will go there to catch up."

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The Scale of Investments: How Much Is a Billion Dollars, Really?

In a world in which the valuations of many firms stretch into the billions or even hundreds of billions of dollars, developing intuition for the scale of such mind-boggling figures is critical. Consider Sirius Satellite Radio, which was valued at more than $8 billion in late 2004, having reported revenue of $19 million and a net loss of $169 million for the previous quarter. Was $8 billion too much to pay for a company with little revenue and a net loss of more than eight times revenue? Since no traditional valuation measure could be used to arrive at an $8 billion valuation, why should the company not be valued at $4 billion, or $16 billion? When a valuation appears to get out of hand, you should ask what else an equivalent sum of money would buy. At $50 per barrel of crude oil, $8 billion would be enough to meet the oil demand of India for almost three months. Or, assuming U.S. per-capita GDP of $37,800, it would take the lifetime GDP of 4,200 Americans to equal $8 billion. Obviously, it would take the lifetime savings of a *multiple* of 4,200 Americans to buy Sirius. Does it make sense that possibly tens of thousands of Americans would have to spend their entire lives working and saving just so they could buy a loss-making company? While this question won't tell you how much Sirius was actually worth, it can alert you to a situation in which the true worth of a company deviates significantly from market "value."

Many investors make the mistake of valuing equities on a relative basis only, or of believing that a discounted cash flow (DCF) analysis, which assumes steadily and perpetually increasing revenue and profit, provides a reasonable absolute valuation measure. Often missing is intuition, which could provide a much-needed sanity check on the rosy projections that inevitably find their way into DCF and P/E-to-growth valuation models.

Fund manager Mohnish Pabrai makes an eloquent case against investing in companies that are too large (in terms of market value). He compares companies to mammals, echoing Charlie Munger's "latticework" approach. According to Pabrai, nature seems to have imposed a size limit on mammals and companies alike. There have never been mammals much larger than an elephant, perhaps because mammals are warm blooded and need much energy to survive. It gets progressively more difficult for the heart to circulate blood to the extremities as a mammal grows larger. Similarly, the top management of a large and growing corporation becomes progressively more removed from the multiplying touch points with customers, suppliers, and partners. This reduces management's effectiveness, eventually causing scale to become a disadvantage, providing competitors with an opportunity to beat the incumbent. Pabrai observes that no company that has been ranked

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first on the Fortune 500 list of most valuable corporations has had net income much in excess of $15 billion (this changed in 2005 when Exxon Mobil posted record profits thanks to runaway oil prices). It seems that any company successful enough to make much more than a billion dollars per month triggers a particularly fierce competitive response and frequently piques the interest of trustbusters.

Owner Mentality

Investment professionalization has had unintended consequences, as the ultimate owners of capital (households and endowments) have become increasingly detached from security selection. Short term-oriented "security holders," such as mutual funds and hedge funds, have displaced long-term "owners." The results have been a greater tendency to choose portfolios that reduce occupational risk rather than investment risk, increased trading mentality, and less participation in company affairs. As Vanguard founder John Bogle points out, "The old own-a-stock industry could hardly afford to take for granted effective corporate governance in the interest of shareholders; the new rent-a-stock industry has little reason to care."

The incentive structure of the asset management industry discourages fund managers from standing up to corporate executives, as funds prize "access" for business and social reasons. When Deutsche Asset Management, a large Hewlett-Packard shareholder in 2002, voted for the contentious HP/Compaq merger, it may have been due to pressure from HP executives. According to a report, "Merger opponent Walter Hewlett has sued HP, saying its management threatened to lock Deutsche Bank, Deutsche Asset Management's parent company, out of future HP investment-banking business if it had voted against [the deal]. Because of that pressure, Hewlett's complaint alleges, Deutsche Bank, which previously had indicated it would vote against the deal, at the last minute switched its votes in favor of it..."

Disintermediation of ownership has placed massive amounts of stock in the hands of mutual funds, likely weakening corporate governance, sustaining excessive executive pay, and tolerating imperialistic M&A. You may agree with my point but wonder how you might have profited from knowing that Deutsche's vote for the HP/Compaq deal might be influenced by factors other than the merits to HP shareholders. Perhaps you could have used a cynical view of Deutsche's incentives as a reason to invest in Compaq, which traded at a wider-than-typical M&A arbitrage spread, reflecting investors' belief that the unsound merger would be called off. The bigger lesson may be to avoid giving your money to entities that have less than your best interests in mind.

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It's hard to overstate how important owner mentality is when investing in stocks. Management works for you, not the other way around. There is no law that prevents an owner from asserting his or her rights, regardless of whether you own one share of stock or a million. Of course, there are practical limits to influencing management as a small shareholder, but you need to think big to succeed. If your analysis shows a company would be a great investment if only you could get management to pay a special dividend, repurchase stock, spin off a division, or remove an underperforming CEO, chances are good that someone with the power to effect such a change (read: a large shareholder or hedge fund) agrees with you. I've been surprised by how often I've invested in companies that ended up announcing seemingly unexpected actions to unlock shareholder value. The only way to find such companies consistently is to think about what changes you would make if you had the power, and how much value such changes would create. If the latter is sufficiently high, you may get rewarded even though someone else will do the hard work.

Assessment of Operating Losses

Many market participants, especially so-called growth investors, exhibit a high tolerance for money-losing companies. An even more common trait is a willingness to ignore "nonrecurring" charges, even though such expenses reduce book value in the same way as recurring expenses. While you clearly wouldn't buy shares in a money-losing company unless you believed in a profitable future or in a favorable sale or liquidation, it seems that many investors' tolerance for losses is exaggerated by the subconscious reassurance that their investment amount is limited and they can't be forced to commit more capital to a company even if it continues to lose money. Though your exposure is indeed legally limited to your initial investment, any impression that someone else will take care of the company's losses is an illusion:

- If other investors end up funding the losses of your company, they will either (1) dilute your interest, or (2) if they lend money to the company, they will increase its interest expense and leverage. Both scenarios are blows to your prospects for a decent return on invested capital.

- If the company is able to fund losses with the liquidity available on the balance sheet, your percentage stake will not get diluted but your book value per share will. The impact of losses, whether recurring or not, on book value is perverse because a 20% drop in book value, for example, requires a 25% subsequent increase just to offset the decline.

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The mindset of Chief Capital Allocator guards against the illusion of low-cost operating losses, because you are more likely to view yourself as responsible for funding those losses. By assuming responsibility for losses, you may decide to scrutinize money-losing companies more carefully.

Warren Buffett: The Ultimate Capital Allocator

It's little surprise that the world's richest investor is a capital allocator rather than a trend follower, "thematic" investor or day trader. Buffett is famous for his buy-and-hold strategy, which has been the hallmark of Berkshire Hathaway's portfolio investments and outright purchases of businesses. Buffett looks to the individual businesses rather than stock certificates to deliver superior compounding of capital over the long term. Buying businesses cheaply has not *generated* his long-term returns — it has merely *accentuated* them.

Buffett raised eyebrows in the investment community many years ago when he bought Coca-Cola at a mid teens multiple of earnings. Most value investors couldn't understand why Buffett considered it a bargain purchase. Of course, Buffett was allocating capital to a superior business at a fair price. He knew that Coca-Cola would compound the capital employed in the business at a high rate for a long time to come. Buffett did not need P/E multiple expansion to make the investment in Coca-Cola pay off.

Similarly, famed value investor Joel Greenblatt paid roughly 20 times earnings for Moody's when it went public almost ten years ago. Greenblatt was allocating capital to a superior business, one that could grow earnings at a high rate without requiring additional capital, thereby freeing up large amounts of cash for share repurchases. Despite trading at roughly 20 times earnings at the time of the IPO, Moody's shares more than quintupled in the subsequent six years.

So next time you log into your brokerage account and feel tempted to put on a trade, cast yourself in your new role as Chief Capital Allocator.

John Mihaljevic is editor of *Downside Protection Report,* a monthly investing newsletter written with a capital allocator's mindset. A subscription is $149/year. Start a free 30-day trial at www.manualofideas.com/trial.html