

# **Red flags, green flags: Signs to note when picking stocks**

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# Disclaimer



**Please note that we do not offer advice about the suitability of our products or any investments held within them.**

**Past performance is not a guide to future performance and some investments need to be held for the long term.**

**The value of investments may go down as well as up and you may not get back your original investment**

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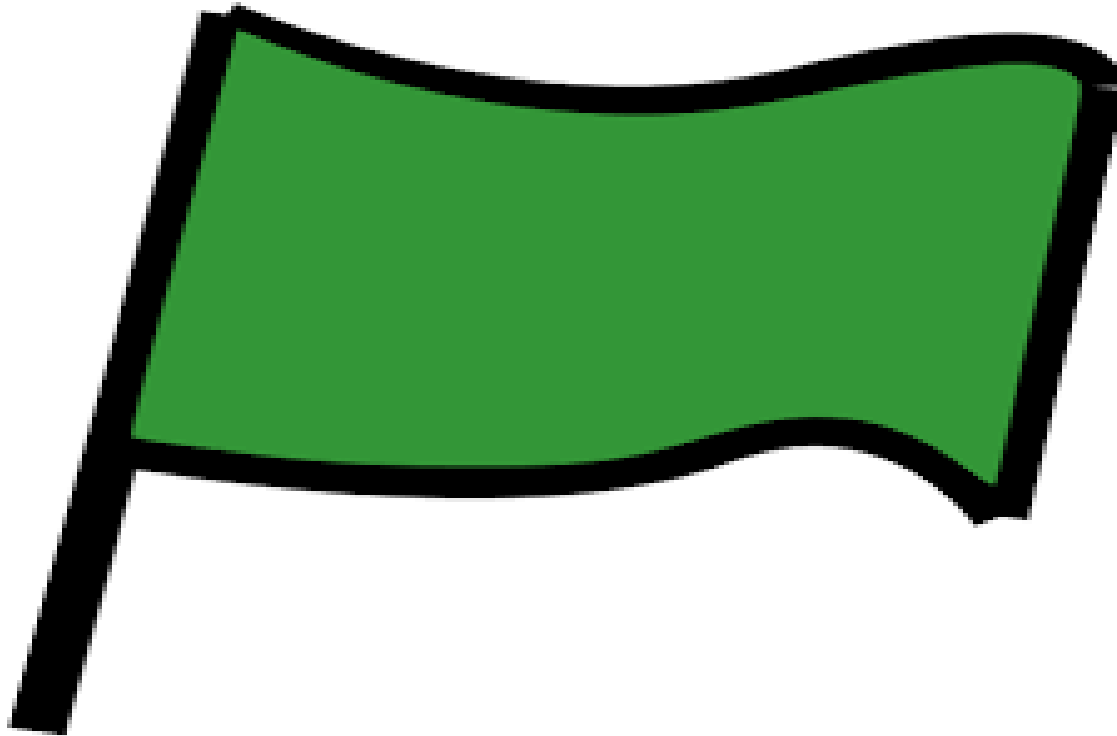
1. Introduction: problem .... and solution
2. Green Flags (and examples)
3. Red Flags (and examples)
4. Conclusion

## Introduction: problem ....

- **Problem:** 'The psychology of human misjudgement .... is a terribly important thing to learn. Terribly smart people make totally bonkers mistakes by failing to pay heed to it.'  
*Charlie Munger (1995 speech at Harvard Law School)*
- **Solution:** Checklists - examples
  - Boeing B-17s
  - Atul Gawande and New York Hospitals



# Green flags

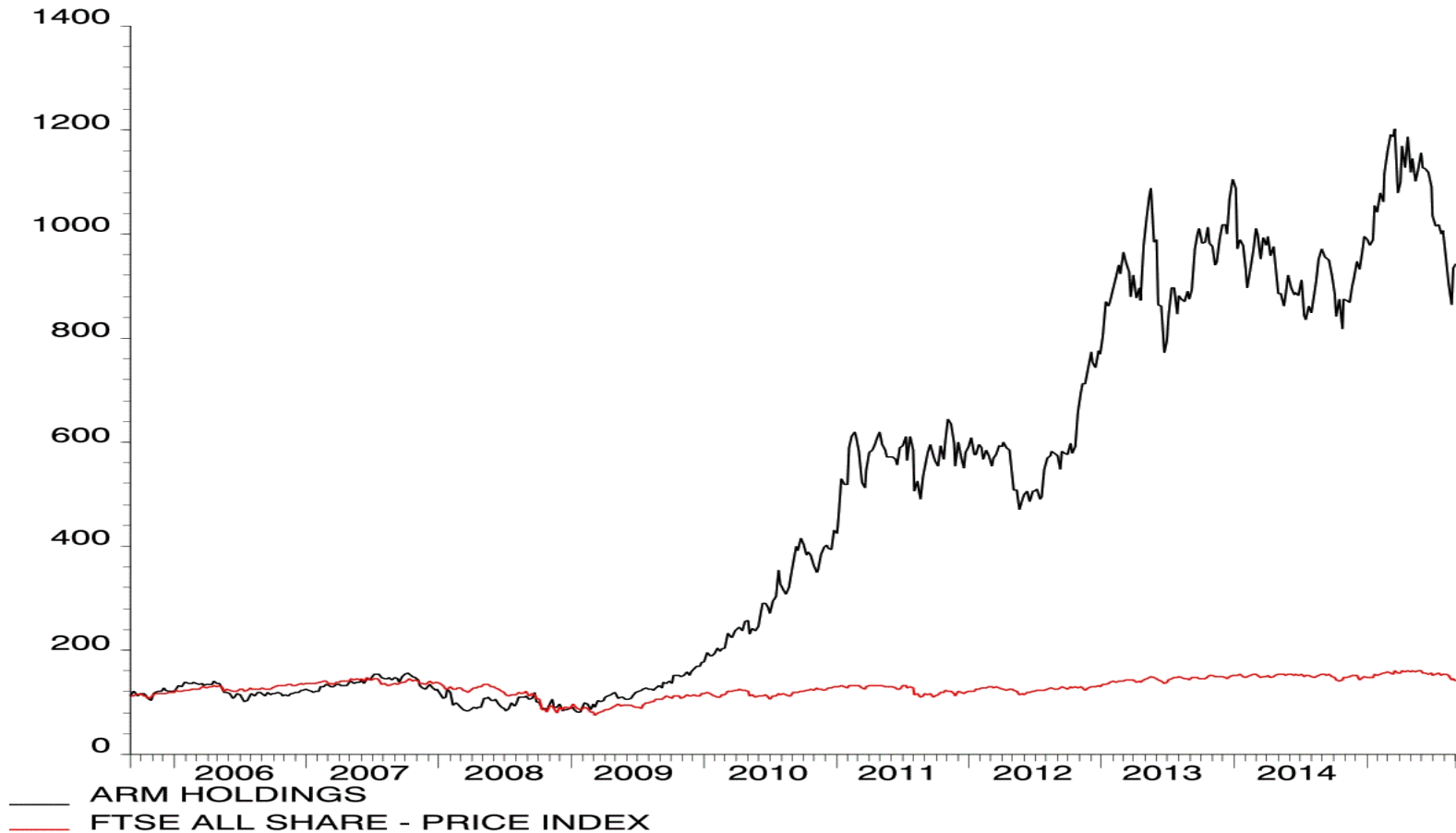


## Green flags: 1 - 5

1. Scalable business model with little need (if any) for capital investment
2. Sustainable competitive advantage and investment made in deepening that advantage
3. Focus on better not cheaper, revenues not costs
4. Pricing power (price x volumes – costs = profit)
5. High cash conversion (net operating cash / operating profit)

# Example 1: Scalable model

07/09/15



Source: Thomson Reuters Datastream

NOTE: Past performance is not a guide to future performance and some investments need to be held for the long term

# Example 2: Pricing power

7/9/15



Source: Thomson Reuters Datastream

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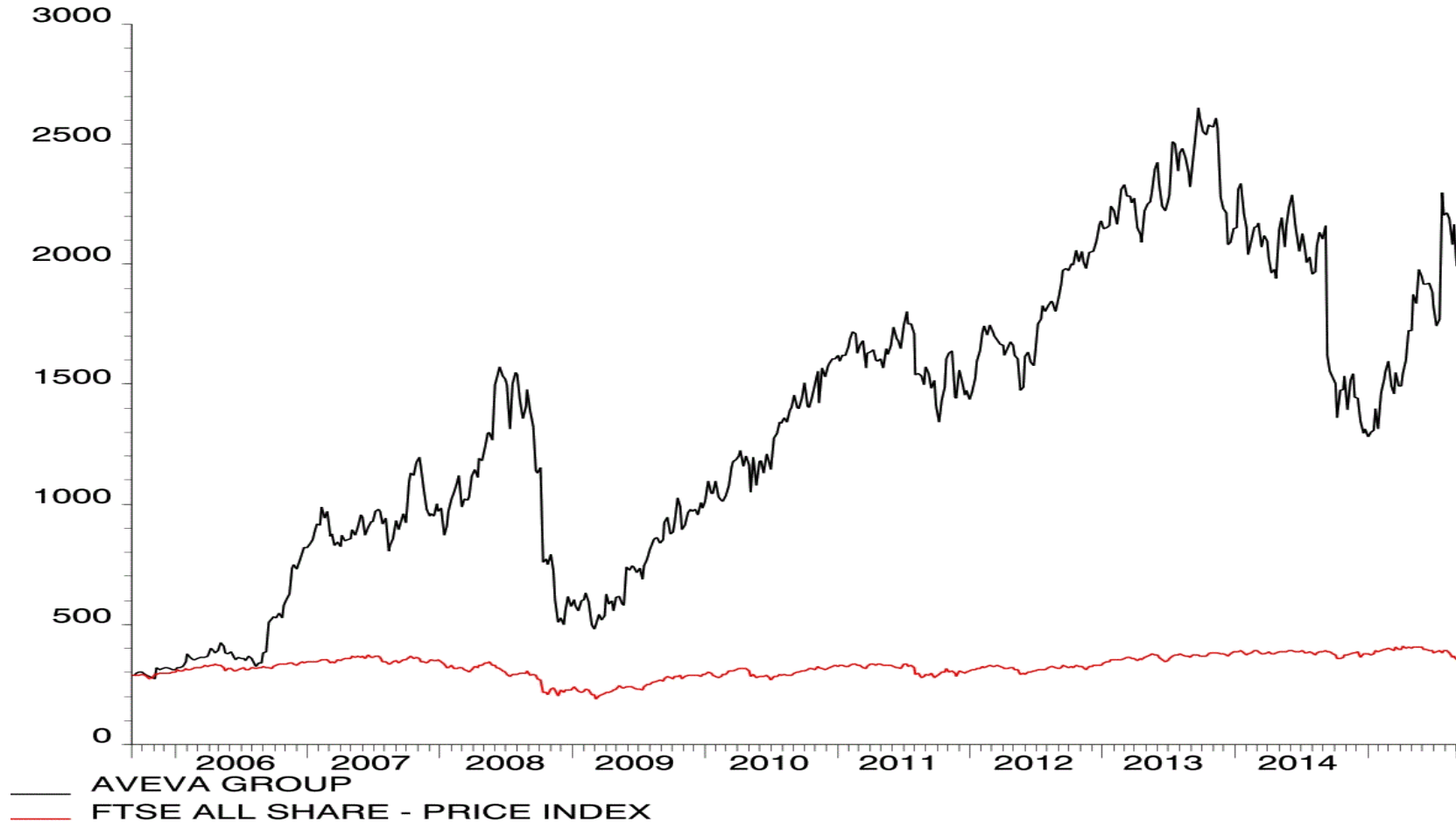


## Green flags: 6 - 10

6. Shareholder value =  $ROIC > WACC$  (not a rising share price!)
7. High free cash flow yield
8. Low / appropriate financial gearing
9. Growing dividend with good cover
10. Strong management with good governance and track record

# Example 3: High ROIC

7/9/15



Source: Thomson Reuters Datastream

NOTE: Past performance is not a guide to future performance and some investments need to be held for the long term

# Example 4: Appropriate gearing

7/9/15



Source: Thomson Reuters Datastream

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# Example 5: Good governance

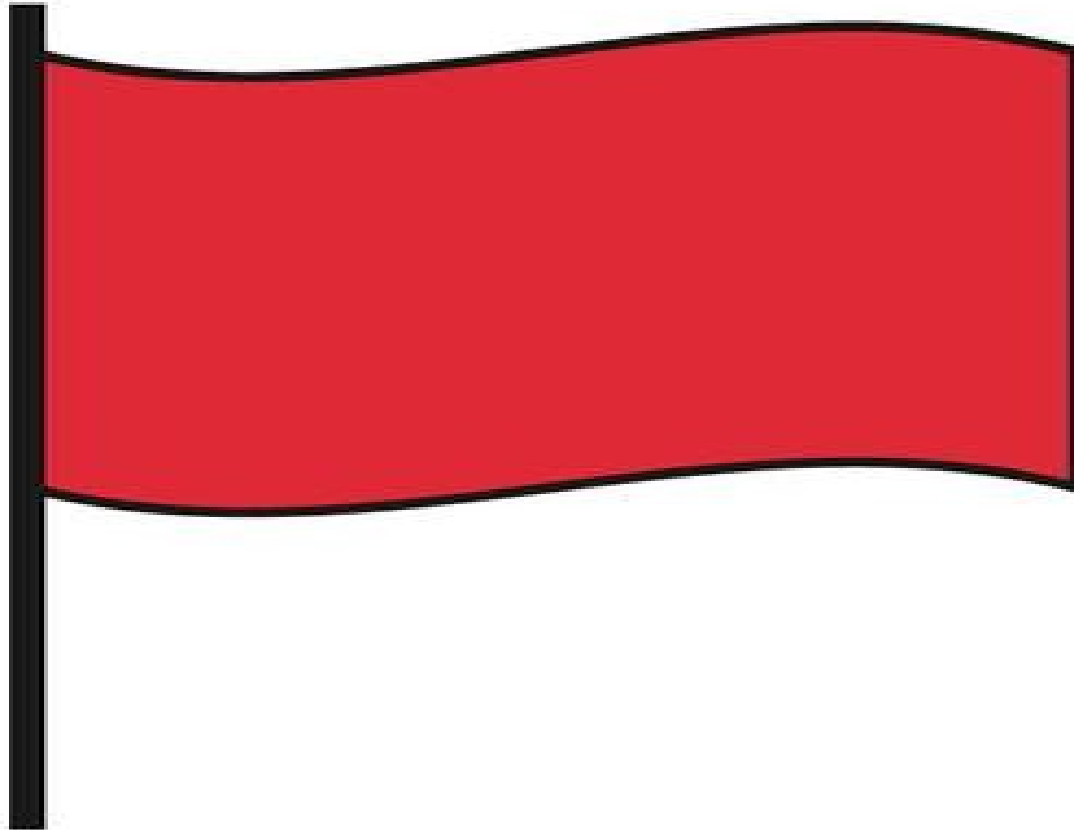
7/9/15



Source: Thomson Reuters Datastream

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# Red flags



## Red Flags: 1 - 5

1. Dominant CEO (whose interests are being served?)
2. Frequent and / or transformational acquisitions
3. Focus on **growth** (growth of **what?**)
4. Management bonuses are triggered easily (EPS)
5. Regular appearance of exceptionals in the numbers and unintelligible footnotes

# Example 1: Dominant CEO

7/9/15



Source: Thomson Reuters Datastream

NOTE: Past performance is not a guide to future performance and some investments need to be held for the long term

# Example 2: Acquisitions

7/9/15



Source: Thomson Reuters Datastream

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# Example 3: Exceptionals

7/9/15



Source: Thomson Reuters Datastream

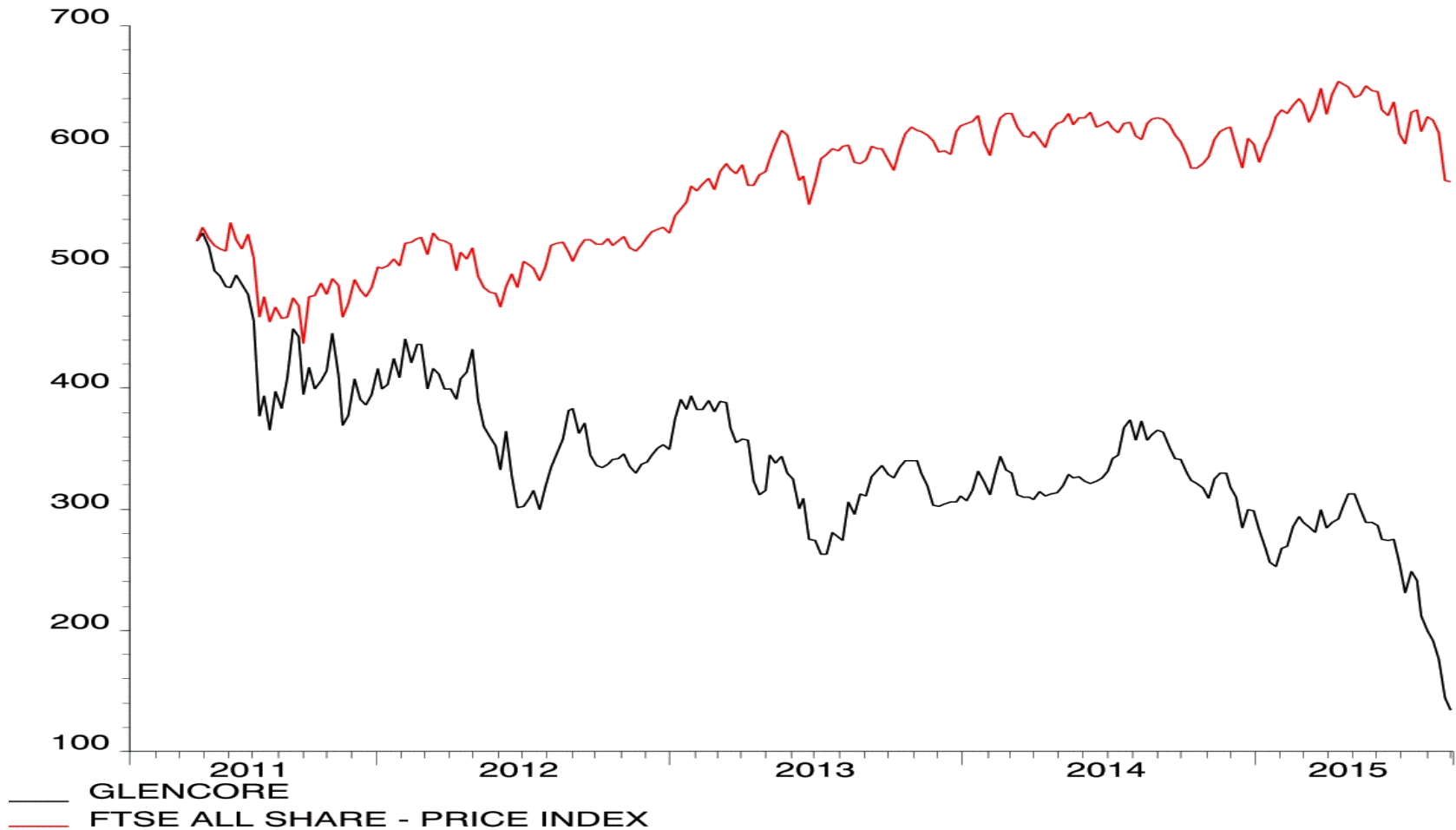
NOTE: Past performance is not a guide to future performance and some investments need to be held for the long term

## Red Flags: 6 - 10

6. Weak cash flow or cash conversion
7. Mix of high operational and financial gearing
8. Interest cover – below 2.0
9. Dividend cover – below 2.0
10. ROIC does not cover WACC

# Example 4: Gearing

7/9/15

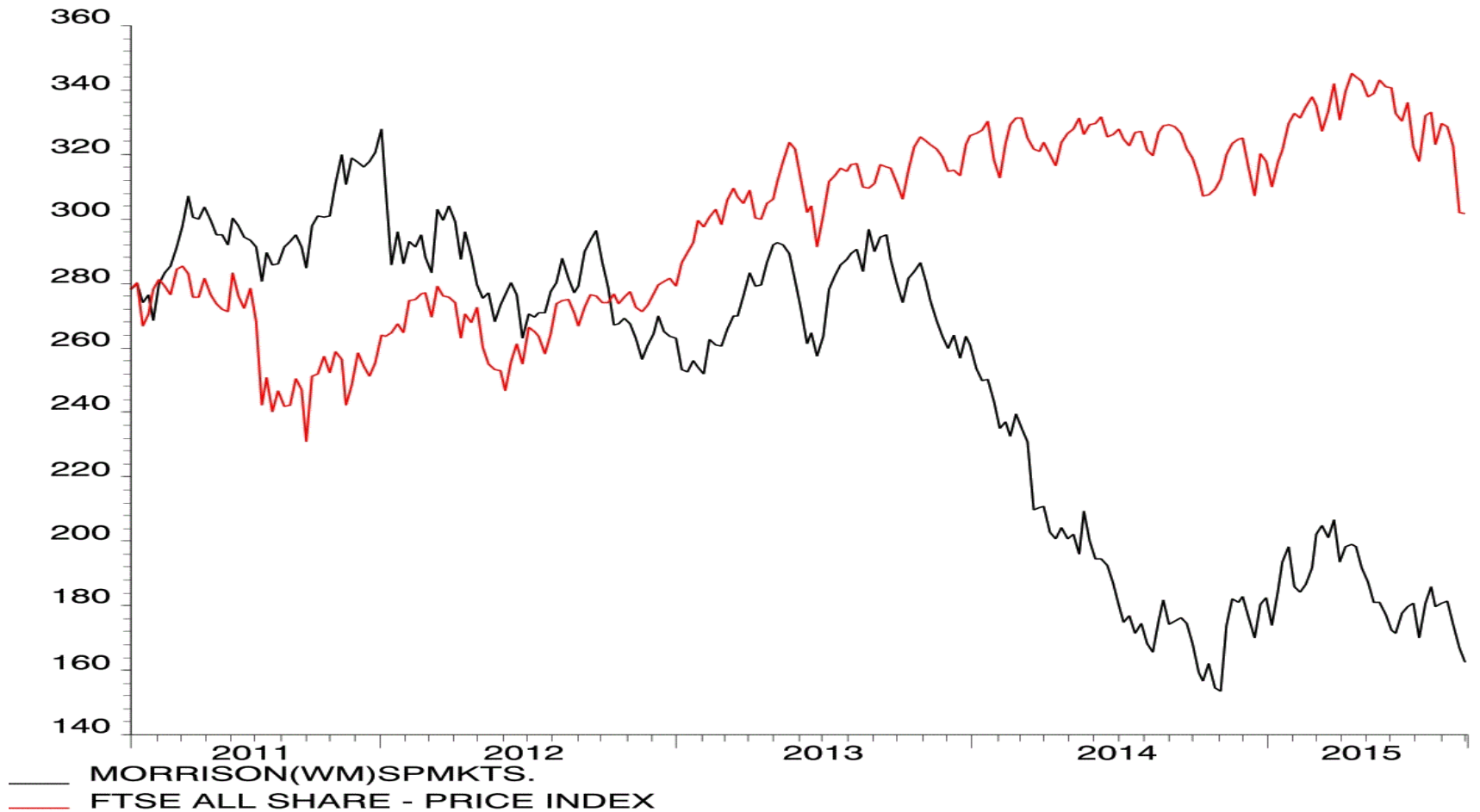


Source: Thomson Reuters Datastream

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# Example 5: Dividend cover

7/9/15



Source: Thomson Reuters Datastream

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# Conclusion

Munger's *Poor Charlie's Almanack* has just **four** investment principles:

- Do we understand the business?
- Does the business have an intrinsic value or durable competitive advantage?
- Does management have high integrity? Do we respect and admire them?
- Reasonable price?

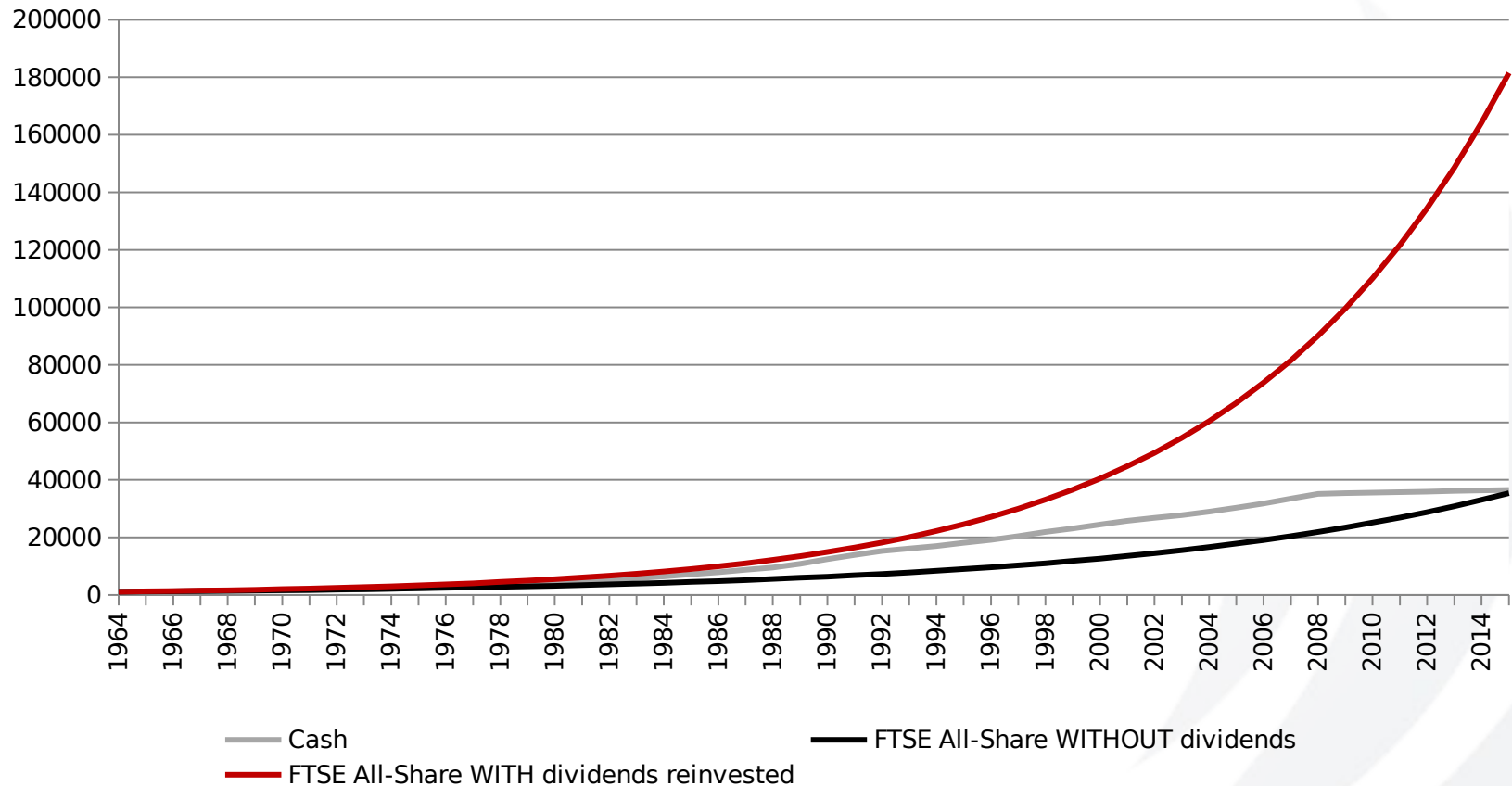
# Keep it simple

- “Investors should remember that excitement and expenses are their enemies.”
- “Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard. If you can enjoy Saturday and Sunday without looking at stock prices, give it a try on weekdays.”

– *Warren Buffett*



# Patience, please!

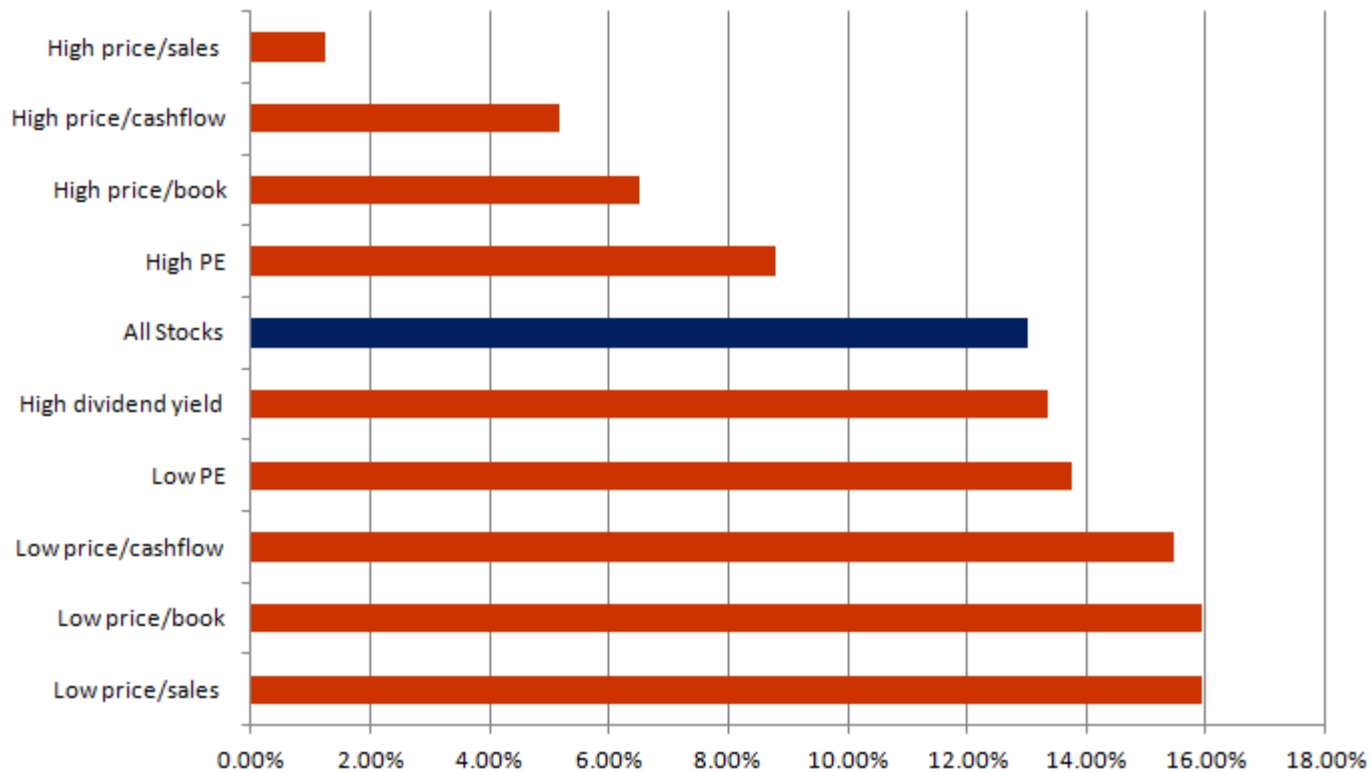


Source: AJ Bell Youinvest, *Shares Magazine*.

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# Reasonable price

- **Compound average annual rates of return 1951-2003: US stocks**



- James P. O'Shaughnessy: *What Works on Wall Street* (hat tip and thanks to Tim Price of PFP Group)

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## Patience, please (again!)

- “Often, there is no correlation between the success of a company’s operations and the success of its stock over a few months or even a few years. In the long term there is a 100% correlation between the success of a company and the success of its stock. It pays to be patient and to own successful companies.”

– *Peter Lynch, Fidelity Magellan Fund*



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