YOUNG INVESTORS SOCIETY

LESSON 6: THE INVESTMENT THESIS

DESCRIPTION

This lesson will teach you the importance of establishing a set of principles that justify why you continue to own or have decided to sell a particular company's stock.

OBJECTIVES

At the conclusion of this lesson, you should be able to:

- Recognize the importance of a creating an Investment Thesis before investing in a stock.
- Identify the importance of staying true to your investment thesis.
- Understanding that the movement of a stock price up or down may not reflect the company's true value.
- Begin to construct a personal Investment Checklist.

LENGTH

Approximately 90 minutes, broken up into Two (2) Sections (30 mins each) and an Activity.

RESOURCES

- Access to a computer and the internet is preferred, but not required
- “Creating Your Investment Checklist” activity
- Zacks.com – for company research including ratios and screens
- YIS Website www.younginvestorssociety.org – curriculum, videos and lesson plans
- Gurufocus.com for company analysis
- Wallstreetsurvivor.com for basic stock concepts
- Yahoo Finance and Yahoo Finance App for stock charts and basic company information
- “The Little Book that Builds Wealth” Pat Dorsey or see Pat Dorsey’s presentation at Google https://www.youtube.com/watch?v=YFS5JBgz1Xc
- Warren Buffett’s Berkshire Hathaway annual reports http://www.berkshirehathaway.com/letters/letters.html
- Guest Speakers (See Guest Speakers Tab at younginvestorssociety.org/mentors)
- Bill Ackman: “Everything You Need to Know About Finance and Investing in Under an Hour” https://www.youtube.com/watch?v=WEDIj9JBTC8
- Seeking Alpha – online portal of stock research reports
- Motley Fool – great daily content and stock picks
- Investopedia.com – the “Wikipedia” of Investing, great online glossary of terms
- Stockcharts.com – for tracking stock market performance and comparison between stocks.
- YIS Glossary of Terms (full database at younginvestorssociety.org/glossary)

INTRODUCTION

Successful businesses start with a clear mission statement. Marriages begin with the exchange of vows. Similarly, successful stock investors begin with a clear investment objective, called an "Investment Thesis". This tells you why you own the stock and what you expect to happen. When deciding what a particular stock is worth, its *intrinsic value*, what we are really asking is "what is it worth *to you*"? A horse is worth more to a farmer than a sailor. A McDonalds happy meal is worth more to kids than, well, any other rational human being. Value is always in the eye of the beholder, and when you buy a stock, the beholder is you. For example, if you need a steady cash payment every year from a stock in the form of a dividend, and a company decides to stop paying its dividend, its Investment Thesis is no longer valid. This is critical to know.

In Lesson 4 we learned about legendary investor Peter Lynch said how he advocated buying companies that you know. He made a fortune off of buying Hanes stock because he wife liked the pantyhose. Peter Lynch said in one of his most famous quotes "*Know What you Own and Know Why You Own It*". In other words, when you buy a stock, you need to know the **WHY**. This is important because the value of a particular stock can rise and fall multiple times in a month, week, day and even in an hour! Instinctively, we want to buy more when a stock price is soaring, and alternatively, we want to sell as soon as possible when the price drops. But many investors get caught up in a "herd mentality" and react to price fluctuations like stampeding cattle based on the direction they perceive the market is heading. Stock prices rise and fall for various reasons as new information (good or bad, accurate or inaccurate) enters the market. In order to know whether this new information should affect your decision to buy, sell or hold stock in a particular company, it is vital that you develop your own "investment thesis."

ESSENTIAL QUESTIONS TO DISCUSS:

1. *Other than in stock investing, can you think something in your life where it is essential to know the "WHY" of what you're doing? How does knowing the "Why" help you succeed?*

LESSON

SECTION 1
WHAT IS AN INVESTMENT THESIS?

Before investing in a company, we need to have a carefully thought out "**Investment Thesis**." An investment thesis is basically a simple and clear description of:

1. Why you own the company.
2. What you expect to happen.
3. What you see that the market does not give the company credit for.

Many experienced investors will tell you that there is hardly anything as valuable in keeping them focused and intellectually honest as this simple exercise. Remember that the principles to successful investing are simple, but the hard part is adhering to them through the ups and downs of the market. In this sense, the investment thesis becomes our anchor, even when the waters get rough or (even more difficult) when the waters stay calm for a deceivingly long time. **If the thesis is still valid, nothing else matters. If the thesis may be at risk, nothing matters more.**

Successful value investor Martin Whitman concluded:

"Based on my own personal experience – both as an investor in recent years and an expert witness in years past – rarely do more than three or four variables really count. Everything else is noise."

So how do we know which variables count and which are just noise?

Let's walk through an example using a company we all know, Apple. If we were going to buy stock in Apple, we would begin by understanding the competitive landscape. We would analyze their smartphone, PC and software peers. We would look at the company's strengths, weaknesses, opportunities and threats (also known as a "**SWOT analysis**"). We would analyze the financial statements and historical returns to shareholders. We would try to speak with someone at the company, speak with their suppliers, speak with customers, and speak with competitors. Now suppose after all of this, we determine that Apple is a great stock to buy. That it has a sustainable competitive advantage, and the stock price is substantially lower than what the business is worth. We then take out a pen and paper (or smartphone) and write down the main points of why we are buying the stock.

A sample "Buy" case Investment Thesis for Apple may look something like this:

- Apple's strong brand will enable the company to sell their products at premium prices. (BRAND)
- Apple's ecosystem of inter-connected apps, videos and music fuels a loyal and sticky user base. (ECOSYSTEM)
- Smartphones and tablets are in their early stages of adoption globally, offering significant growth potential. (GROWTH)
- Apple's management promotes a culture of innovation and design for consumer electronics, creating a platform for future product launches. (CULTURE)

On the other hand, maybe our research uncovers some concerns about that company so that we feel that Apple's current position may not be sustainable going forward and that the company is a "Sell". We may even short the stock, hoping to profit from its decline.

A "Sell" Investment Thesis for Apple may look something like this:

- Apple competes in the highly competitive industries of PC and smartphones.
- History has proven that commoditization for consumer electronics industry is inevitable, which makes Apple's premium prices and exceptionally high margins unsustainable.
- After the death of Steve Jobs, Apple's product innovation has noticeably deteriorated.
- Apple is heavily reliant on their supply chain of components, which they do not control, and which will limit future innovation.

Which thesis do you agree with? Perhaps more important than being right, is the mere fact that you are making a choice, writing it down, and constantly keeping yourself honest by referring back to it. Of course, that being said, you also want to be right!

Let's assume that you believe the first scenario, and you go ahead and buy shares in Apple. You sit happy knowing that every time someone in the world that goes out and buys and iPhone, they are earning you a small share of that profit. You even go out and buy yourself a new iPhone using that same argument, fantastic! But then the news starts pouring in: Samsung is launching a fancy newfangled smartphone next month. Apple's quarterly earnings were 10% below expectations and suddenly the stock drops by 20%. CEO Tim Cook is having a bad hair day. What is going on?! Every day we wake up to either panic or euphoria in the news – how do we keep it all straight?

There is one simple trick -- constantly ask yourself the same question:

"Is the investment thesis still intact?"

For example:

Does Samsung's new smartphone have any impact on Apple's (1) brand power, (2) ecosystem, (3) growth, or (4) culture of innovation? If not, then it's just noise.

Does Apple's earnings for the quarter indicate anything about the company's (1) brand power, (2) ecosystem, (3) growth, or (4) culture of innovation? If not, then it's just noise.

Does Tim Cook's hairdo present any risk to the company's (1) brand power, (2) ecosystem, (3) growth, or (4) culture of innovation? Possibly, then for heaven sakes, get the man a comb! If not, then it's just noise.

When we develop the habit of constantly checking new information against our investment thesis, we learn to effectively filter out the noise.

But then let's say that through conversations with second-hand resellers of Apple products, we find out that a one-year old used iPhone that used to sell for $400 is now selling for $300. We inquire as to why, and we are told that customers are telling us that there are other phones available that are nearly as good and they simply aren't willing to pay a higher price for an iPhone. We also find that carriers are saying the same things. Now, we can legitimately begin to worry. There may be a crack forming in Point #1 ("Apple's strong brand power will enable the company to sell their products at premium prices"). If we find we can no longer defend a key point of the investment thesis, then we sell the company. Period. It is simply not worth the time and the risk.

GROUP DISCUSSION QUESTIONS:

1. *Do you agree more with Investment Thesis of "Buy" of Apple, or "Sell"?*
2. *Compare the Apple today vs. Apple of 2010, before the death of Steve Jobs, has the Investment Thesis been strengthened or weakened since then? What is the evidence to support your view?*

SECTION 2

Case Study:

Portfolio Manager and founder of YIS, James Fletcher learned the power of the Investment Thesis early in his investment career. In 2007, he came across a company from South Korea that made online video games. Their existing games had a remarkably sticky user base paying subscription fees every month. The games had two powerful things that he looks for in companies: (1) a network effect -- the more kids that played the game the more attractive the game becomes and (2) high switching costs -- when someone invests seven years leveling up a character and amassing virtual items, they were unlikely to switch to another game and have to start over. The company had a rare competitive moat that was both wide and deep. But they hadn't had a hit game in a while, so the market was rather gloomy on the company despite what was considered to be a top-notch development team. As any parent who has had to try and pick a video game for their kids, the video game industry is an unpredictable "hit or miss" industry. Trying to forecast whether a game will be a hit is very difficult. It's often a roll of the dice. However, James took a long-term approach and built an investment thesis on three pillars:

(1) the existing games would continue to retain their loyal user base and pay handsome returns,
(2) despite being a "hit-or-miss" industry, the development team would eventually get a hit,
(3) the current stock price implied no probability to a new game success.

Shortly after buying the stock, the company launched a new flagship game. Here it was! The game had all the makings of a blockbuster: substantial buzz in the gaming community, a legendary lead-developer, three full years of development, a huge marketing budget, and positive reviews. The game hit the shelves, and then... it flopped! It just simply didn't sell. James watched the stock price fall for the company by nearly 50% in a month. He felt sick to his stomach! He stumbled back to the drawing board -- his investment thesis -- and asked himself: was the original investment premise intact?

1. Did the company still have a sticky, loyal user base on existing games? Yes.
2. Was the development team still likely to have a hit game in the future? Yes.
3. Was the stock undervalued? Yes, even more so.

This meant that all of the despair in the market was actually just noise. Feeling a bit more comforted after reviewing the investment thesis, he continued to hold the stock. In 2008, the company launched another game. This time, expectations were even higher. The launch was timed for the holiday season and the game was a mix between car racing and online fighting-- which every industry expert believed was a sure formula for success. The game hit the shelves and low and behold...another flop! The game mostly sat on the shelves and everyone that bought the game ended up returning it because there was no one online to play it with. Investors were exasperated and the stock plummeted by another 40%. James' clients began to notice poor performance. At this point, to his knowledge, James's company and its clients remained the only international shareholders to continue to own the stock, which by default made them feel both stupid and lonely. They even had the audacity to add to our position. But here is the reason why: **not one thing had changed from the original investment thesis, except for the fact that the stock price looked a whole lot more attractive now than it ever had!**

Some may call this sticking to your guns. Some may call this being just flat-out stubborn. Investors like to refer to this as "high conviction." Despite what you call it, however, James' conviction came from having a clearly defined investment thesis, giving him the ability to block out the noise.

The following year, the company launched another game that was largely ignored by the market because it was more of a niche game for an Asian audience. Everyone's expectations were rock bottom after the previous failures. The game was released and turned out to be one of the bestselling video games of all-time in Korea, and then later, a blockbuster hit in China. The stock price shot through the roof. Two years later the company followed it up with another successful game launch, and the stock climbed even higher. From James' initial investment, he had now made over a 500% return. He and his clients were dancing in the aisles.

Looking back, James recounts that the success was basically due to just one factor: “that I had written down those three simple bullet points down from the very beginning”. He says if he had not he surely would have sold his shares when times got rough. Without the rock-solid conviction of why they owned it, they would have followed the herd and cut their losses. He was grateful he stayed true to his investment thesis.

GROUP DISCUSSION QUESTIONS:

1. *Discuss the reasons why it's difficult to keep holding a good stock when it is going down?*
2. *Discuss the reasons why it's difficult to sell a stock that you bought whose investment thesis may not be valid anymore?*

CONCLUSION

In order to invest with confidence and properly filter out noise that might intimidate you, confuse you and cause you to make emotional decisions that could cost you money, it is important that you create an investment thesis of your own for every stock that you buy.

Summary:

- Know the stocks you own and know why you own them.
- Creating and constantly re-evaluating an investment thesis is the most crucial tool to keep investors on-track and disciplined.
- If news doesn’t impact the investment thesis then it is just noise. If new data gives us either higher conviction or higher concerns in our investment thesis, nothing matters more.

ACTIVITY

Creating Your Own Investment Checklist

Going hand in hand with creating an Investment Thesis for the each of the stocks that you own, is creating an overarching **Investment Checklist.** An Investment Checklist is the summary of your personal investment process. The idea of an investment checklist was created by famed investor Mohnish Pabrai, whose fund has earned a 517% return compared to the S&P 500 up 43% since 2000. The idea, according to Pabrai, is to create a series of Yes or No questions to ask yourself before investing in a stock to make sure you don't miss anything or make a mistake. A good Investment Checklist is like a constitution, a series of personal rules to make sure that you stay disciplined and focused. The goal is create a series of over-arching questions that will maximize your chances of finding great investments and minimize the chances of investing in a dud. Many successful investors such as Guy Spier and Charlie Munger (partner to Warren Buffet) also attribute the use of Investment Checklists as one of the hallmarks of their success.

Below is an interview with Mohnish Pabrai talking about how he uses Investment Checklists

.
https://www.youtube.com/watch?v=vkEUd_aju8c

It is never too early to start thinking about and creating your ***own*** Investment Checklist. Reflecting back on the things you have learned about investing through your YIS participation and other sources, consider the elements of what makes a company an attractive investment (e.g., strategic advantage or economic moat). Consider the case studies above and other companies that have been analyzed during your YIS meetings. What are some of the characteristics of successful companies and investments that justify acquiring stock in the company? What are some red flags in investing that you want to make sure that you avoid?

Here are some examples of possible questions for an Investment Checklist:

1. Do I understand what is moving the stock price, what the market is pricing in, and where my view may be different?
2. Do I understand how the company earns money?
3. Does the company have a clear competitive moat?
4. Have I reached the investment conclusion on my own, and believe that even if people that like the stock now reversed their opinion, it wouldn't sway me?

Hint: Be sure to structure the checklist so for all the questions "Yes" means it's good to invest and "No" means don't invest.

Activity - Take 15 minutes and write down a few points that you want to be in your own investment checklist. When you are done, break into groups of four and share your investment checklist with your peers. Be open to any additional insights or suggestions that your peers may have regarding how you might improve and clarify your investment checklist.

Type your investment thesis on one page of paper, print it, and if possible, laminate it or use contact paper to preserve it. Commit to post your investment thesis in a place where you can review it when you review, execute trades and conduct your investment analysis.

PREPARING FOR THE YIS STOCK PITCH COMPETITION

Provide 10-20 minutes each meeting for the students to work on their individual Stock Pitch project for the YIS National Stock Pitch Competition or for Online Stock Idea Competitions.

In preparing for the YIS National Stock Pitch Competition (see Competition Guidelines) you should start thinking about creating an investment thesis that will help you justify why you recommend owning that stock. You should be able to articulate:

1. Why you own the company.
2. What you expect to happen.
3. What you see that the market does not give the company credit for.

FOLLOW-UP IDEAS

Some ideas to further explore the concepts covered here are:

- Contact a stock market professional to discuss what his personal investment thesis is for companies he owns.

- Write down your investment thesis, print it and pull it out each time you analyze what stocks you own, plan to purchase and are considering selling.
- Schedule time quarterly and annually to review and analyze your investment thesis and determine whether it needs to be modified in any way.

GLOSSARY OF TERMS

- **Investment Thesis** – The basic guiding principles an investor establishes to justify:
    - Why he owns the company
    - What he expects to happen
    - What he sees that the market does not give the company credit for

- **Economic Moat** – The competitive advantage that one company has over other companies in the same industry. This term was coined by renowned investor Warren Buffett.

- **Brand** – A distinguishing symbol, mark, logo, name, word, sentence or a combination of these items that companies use to distinguish their product from others in the market. Brand equity is the positive sentiment created by a product among its target audience over time.

- **Switching Costs** – The inconveniences that dissuade a customer from switching to a competitor. The negative costs that a consumer incurs as a result of changing suppliers, brands or products. Although most prevalent switching costs are monetary in nature, there are also psychological, effort and time-based switching costs.

- **Network Effect** – A phenomenon whereby a good or service becomes more valuable when more people use it.

- **Low Cost Advantage** – A sustainable advantage driven by access to a unique process, location, scale, labor costs or access to a unique asset, which allows a company to offer goods or services at a lower cost than competitors.

- **Intrinsic Value** – What a stock is truly worth, not necessarily what the current stock price is.

- **Dividend** – The portion of a company's profits that it pays out each year to shareholders in the form of cash.

- **SWOT Analysis** – A comprehensive analysis of a company's Strengths, Weaknesses, Opportunities and Threats.

- **Shorting a stock** – Borrowing against the shares of stock, you profit when the stock price goes down.

- **Profit Margins** – The ratio of profits made per dollar of revenue. The higher the profit margin the better.

FOR INSTRUCTORS: LESSON 3 ANSWER KEY

ANSWERS

ESSENTIAL QUESTIONS:

1. *Other than in stock investing, can you think something in your life where it is essential to know the "WHY" of what you're doing? How does knowing the "Why" help you succeed?*

   Answers could include playing sports, learning to play a musical instrument, going to college, volunteering in the community. Knowing the "Why" helps you succeed because it keeps you focused, it helps you keep giving your all even when you're not seeing immediate rewards from it, and it helps you stay focused on the big picture.

2. *Do you agree more with Investment Thesis of "Buy" of Apple, or "Sell"?*

   Both could be justified.

3. *Compare the Apple today vs. Apple of 2010, before the death of Steve Jobs, has the Investment Thesis been strengthened or weakened since then? What is the evidence to support your view?*

   Most likely the competitive position has weakened. Innovation has slowed down, the Apple Watch was a disappointment. Apple is facing more competition from Samsung and other smartphone manufacturers, Android is gaining share. But at the same time, they still have a robust ecosystem and strong brand. Most likely the ecosystem has probably strengthened, but the culture and the brand may be a little diminished but still both strong.

4. *Discuss the reasons why it's difficult to keep holding a good stock when it is going down?*

   There are many pressure to sell a stock when it is declining including fear of losing more money, herd mentality, peer pressure, complaints from clients, risks that things may get worse (you may "catch a falling knife".

5. *Discuss the reasons why it's difficult to sell a stock that you bought whose investment thesis may not be valid anymore?*

   It is against human nature to admit that you were wrong, there is a strong bias toward "breaking even" on a stock, there is a fine line between conviction and stubbornness, it is easier to hope that things improve than admit that you made a mistake, a company's management may convince you that everything is ok even when it isn't.

ACTIVITY

An investor checklist should be different for everyone, depending on their risk tolerance, investment philosophy, and personal biases. To learn more about investment checklists, see the following site:

http://davidparmenter.com/files/buffet-checklist-v4.pdf

TIPS FOR TEACHING

1. Let the kids run YIS as much as possible. Choose a class leader as the portfolio manager of the day. Assign kids to present something ahead of time, either a section of the lesson, or a "Topical Presentation" about something happening in the market. The more the kids are teaching each other and engaging in lively discussion, the better.
2. Hands on, real life examples should be the focus. Feel free to bring in other company examples to supplement the lesson material. Go on to Zacks.com to research company fundamentals of the companies you are talking about.
3. For "Essential Discussions" consider breaking the group up into small groups or pairs to discuss and then have a couple present their thoughts to the class. Try "Pair, Square, Share" Technique, which discuss in pairs, then in fours, then share with the group.
4. Invite guest speakers to come in, either from a local business or from the investment community.
5. When kids have a question, encourage them to find the answer themselves rather than spoon feeding the answer to them. Open it up to the group to answer. Don't worry if you don't know the answer. If you're stumped search online or contact your YIS representative.
6. Guide instruction and activities back to preparing their Stock Pitch Idea. Use the stock ideas they are working on as the main examples in the lesson.
7. Make it fun! Investing isn't easy, but it is definitely exciting so look for ways to make teaching exciting, unpredictable, and interactive. Encourage kids to participate in "Wall Street Survivor" leagues to start with mock portfolios, participate in YIS contests, and eventually buying stocks through the "Dollar-a-Day" Challenge.
8. Remember, you're awesome! You're building the next generation of great investors, teaching the skills and habits to build wealth and change lives for generations to come.
9.

FREQUENTLY ASKED QUESTIONS