

# "Other Voices," *Barron's*, Sept. 12, 2005

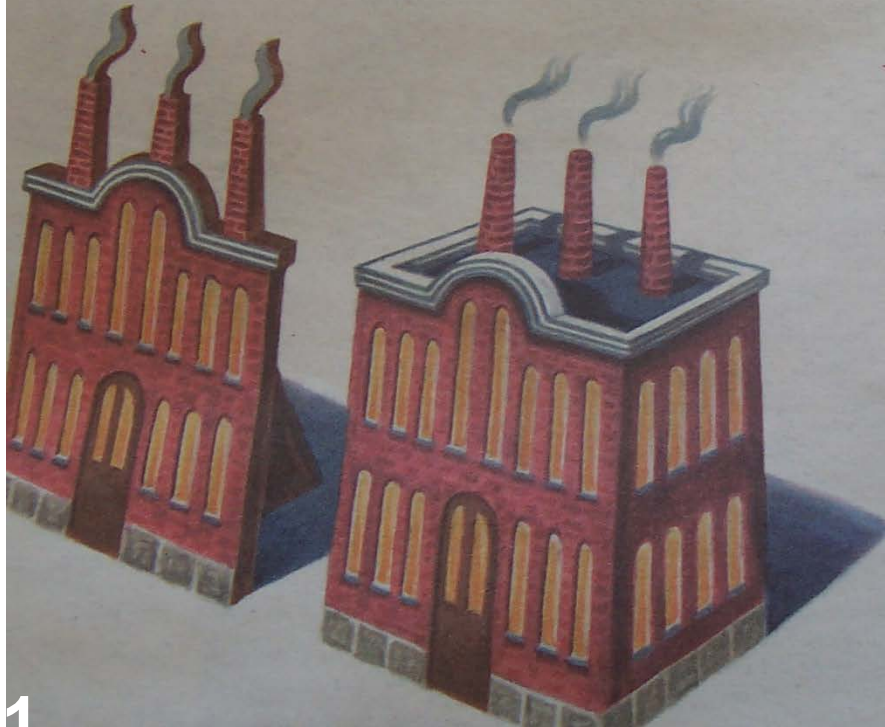
62

BARRON'S

## Other Voices

Views from beyond the *Barron's* staff ■ by Hewitt Heiserman Jr.

# The Power of Earnings Power



nately, the income statement contained in every annual report, 10-K and 10-Q doesn't meet the needs of either personality type.

For our defensive investor, omitting investment in fixed and working capital are limitations because they are uses of cash. A company goes bankrupt not for a lack of earnings, but for a lack of cash. Therefore, the defensive income statement expenses all investment as incurred. If the business still makes money after deducting both these outlays (plus, of course, all other operating costs), then it has a defensive profit.

A defensive profit tells you the company is able to self-fund growth via internally generated free cash flow. A defensive loss, however, forces management to deplete the checking account, liquidate assets, sell more stock or visit the banker's window. None of these options benefits stockholders.

In 2000, Enron made \$896 million by GAAP. But it lost \$3.1 billion on a defensive basis. The \$4 billion gap came from large investments in fixed and working capital.

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# Ben Graham and the Growth Investor

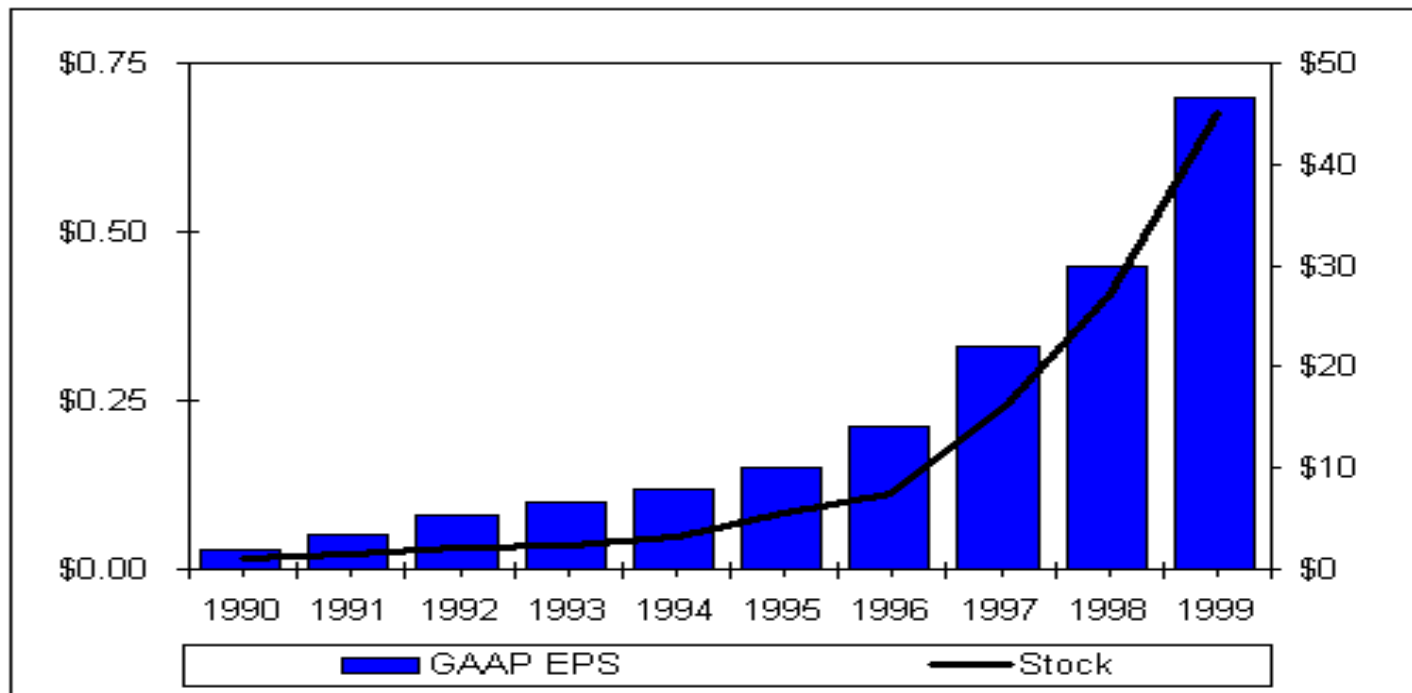
HEWITT HEISERMAN JR.  
[www.EarningsPower.com](http://www.EarningsPower.com)

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Earnings Power Chart and Earnings Power Staircase are property of Hewitt Heiserman Jr.  
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# Microsoft in the 1990s: A Growth Investor's Dream

Microsoft (MSFT)



GAAP EPS

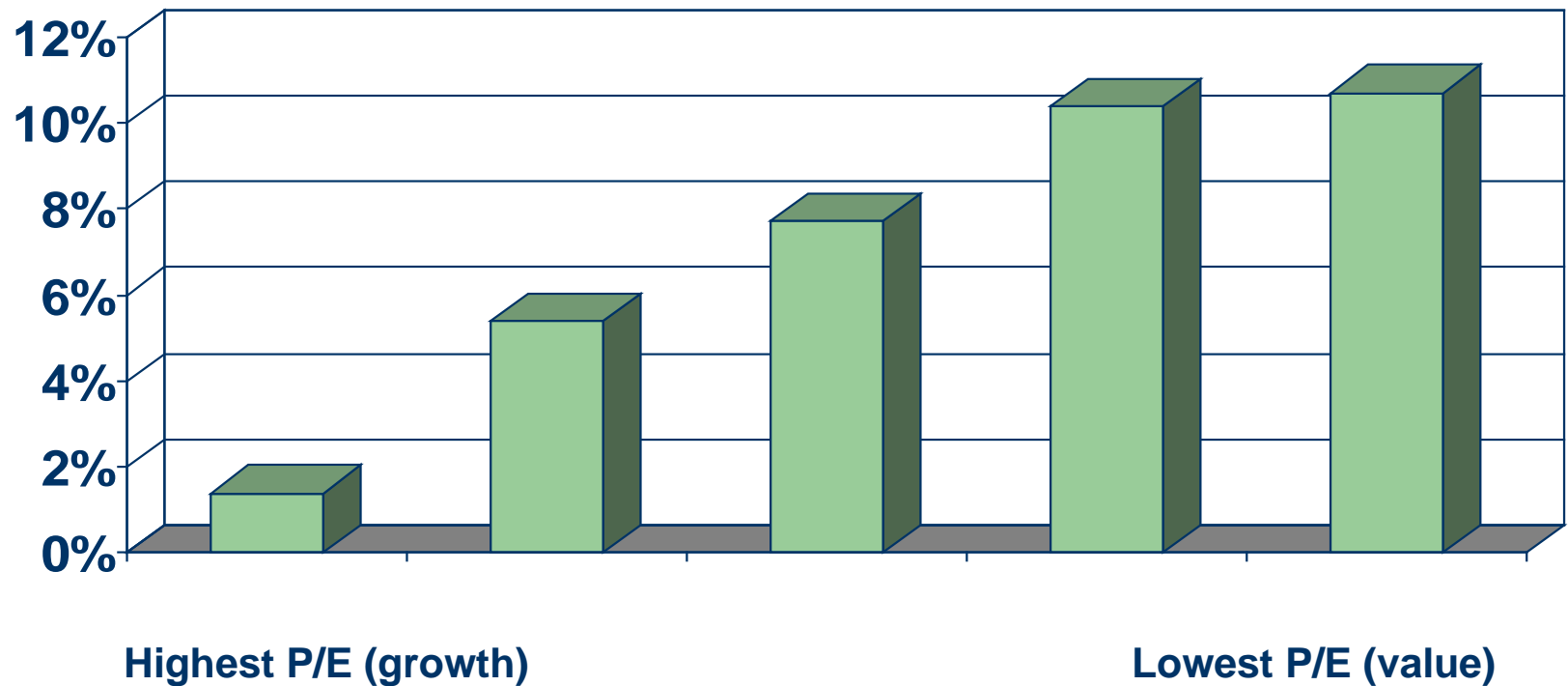
Stock Price

## Benefits of Growth Investing

- Asymmetric reward-risk. Worst-case, investment goes to zero. Best-case, unlimited upside. During 1990s, a hypothetical \$10K investment grew to almost \$1 million
- Defer capital gains taxes—your principal compounds faster
- Save money on commissions, bid-ask slippage costs
- Trade less, which improves investing results
- No “exquisite timing” required; you can build a position over many years

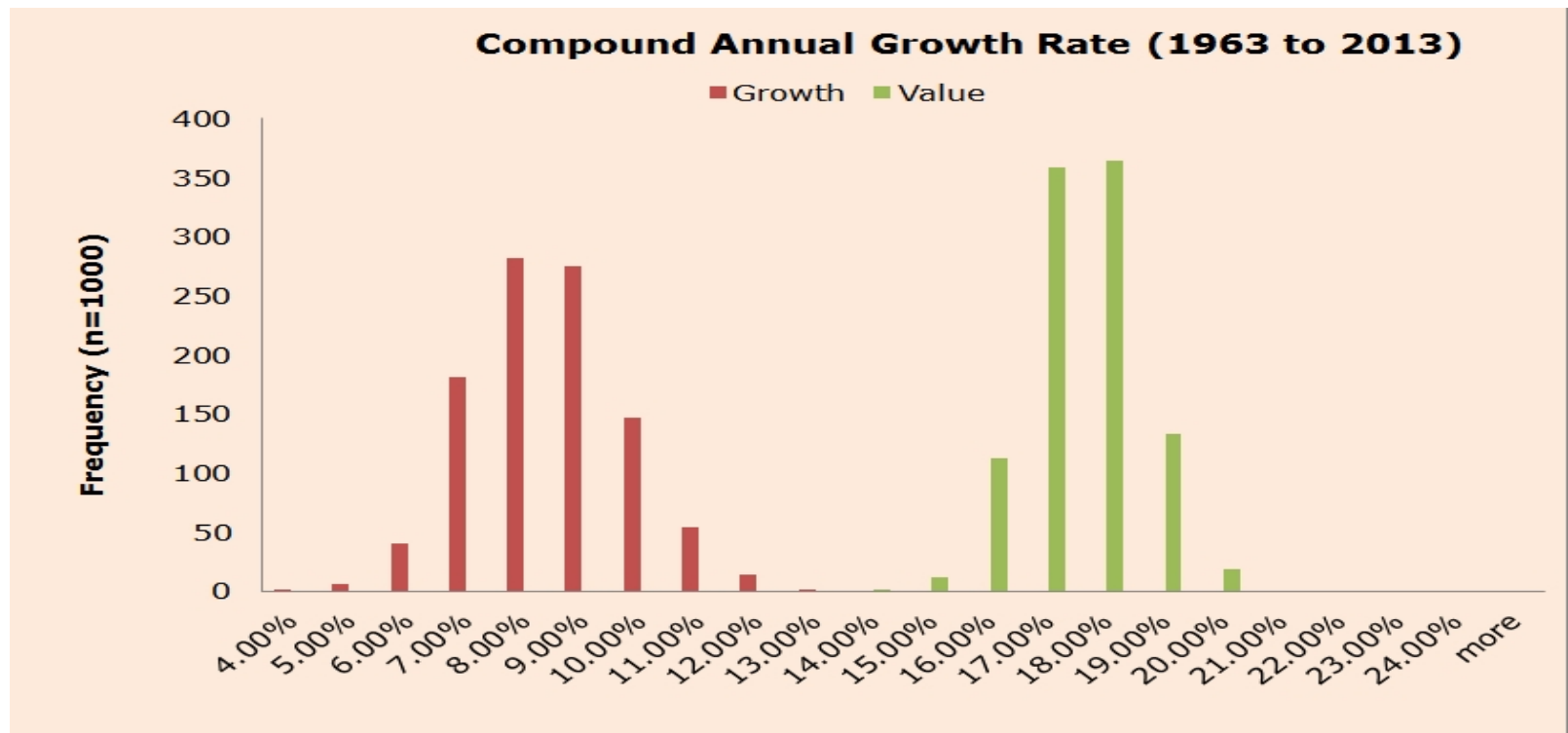
## But: Growth Stocks = Low Subsequent Returns

10-Year Avg. Annual Real Returns for S&P 500, 1926-9/2007



Source: Jeremy Grantham, GMO, Oct. 2007

## Also, Value Beats Growth (EBIT/TEV)



Source: Wesley R. Gray, "Never Buy Expensive Stocks. Period.," <http://www.alphaarchitect.com/blog/2014/07/01/never-buy-expensive-stocks-period/#.VKBrHUAKA>

## The Growth Trap – Three (3) Obstacles:

1. Poor earnings quality	GAAP income statement has four (4) structural limitations. So, just because a company is profitable in the accounting sense of the word does not mean that it has authentic earnings power.
2. Competitive advantage wanes	Successful companies attract imitators—good for consumers, bad for owners.
3. Premium to intrinsic value	We predict by extrapolation, so growth stocks often get pushed beyond intrinsic value (fair worth).

## Obstacle #1: Poor Earnings Quality

- To create comparability, all U.S. companies follow generally accepted accounting principals (GAAP)
- GAAP is Robert's Rules of Order for corporate America
- When you open an annual report, 10-K or 10-Q and look at financials statements, that's GAAP
- Many investors take GAAP net income at face value; they think net income and EPS is a "hard" number...



...like height Fenway's Green Monster (37')



## Wrong! GAAP P&L's Four (4) Structural Limitations

1. Omits investment in **fixed capital** , so when capex is greater than depreciation, the net cash drain is excluded
2. Omits investment in **working capital**, so when receivables and inventory grow faster than payables and accrued expenses, the net cash drain is excluded.
3. **Intangible growth-producing initiatives** like R&D, promo/advertising, employee education, etc. are expenses (i.e., *not* investments) even though the benefits will last for several accounting periods.
4. **Stockholders' equity** is free even though owners have an opportunity cost.

## How Fix? In the 1990s Two Alternate P&L's Emerged

	<b>Free Cash Flow</b>	<b>Economic Value Added</b>
Adjustments:	#1. Expenses investment in fixed capital; #2. Expenses investment in working capital;	#3. Capitalize intangibles and then depreciate over useful life; #4. Stockholders' equity is an expense
Profit type:	Free cash flow	Economic Value Added
Goal:	Self-fund? A company does so when it produces more cash from ongoing operations than it consumes.	Create value? A company does so when it produces a return on capital that is greater than its cost.
Personality:	Commercial banker	Venture capitalist
Limitations:	Intangibles are expensed; stockholders' equity is free	Investment in fixed, working capital are expensed

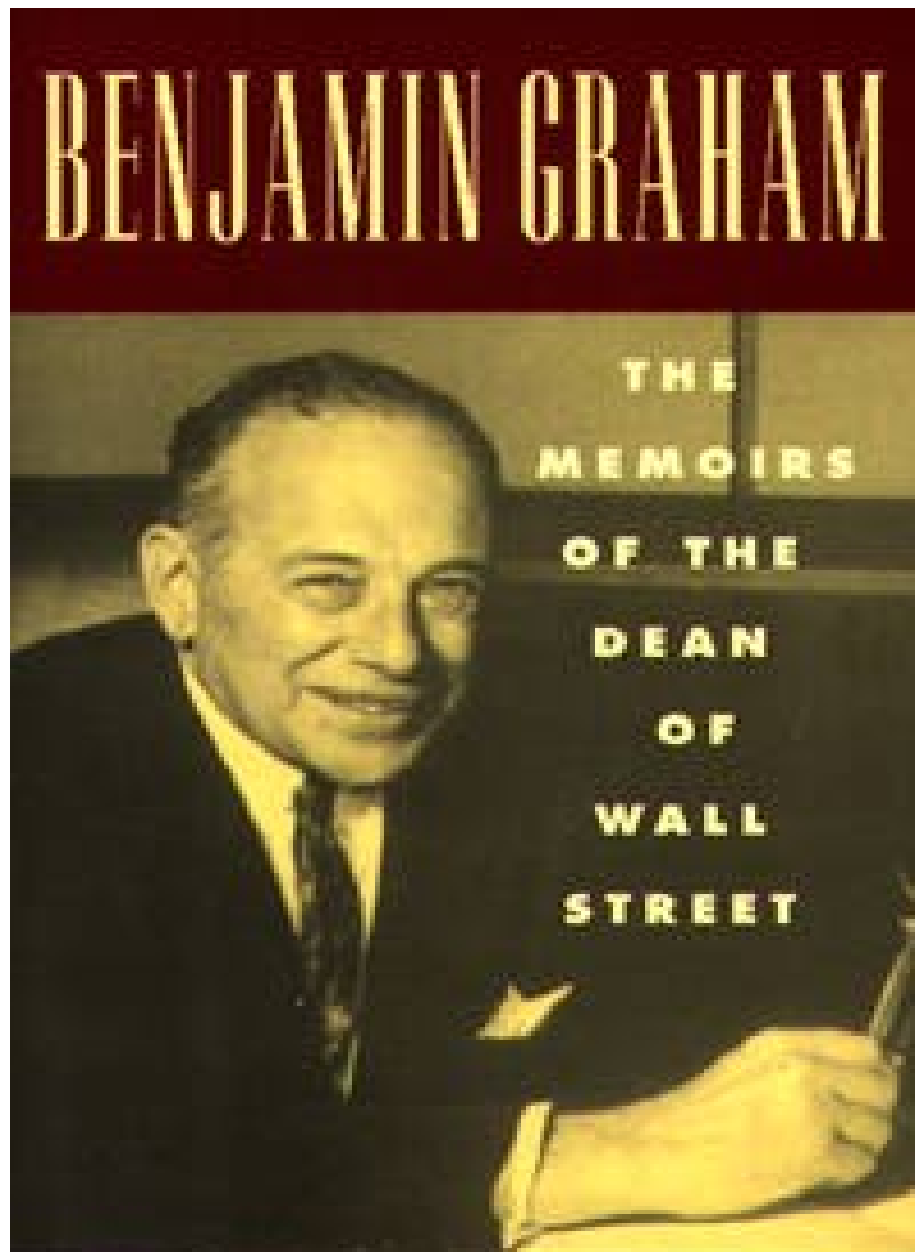
## Quandry?

- When use free cash flow income statement?
- When use Economic Value Added?
- Well, reading Ben Graham gives me an idea...



Not this  
Ben  
Graham!

\*Jets punter 2005-2008



This fellow!  
(1894-1976)

## *The Intelligent Investor*: Graham's Two Types

- “The **defensive** (or passive) investor will place his chief emphasis on the avoidance of serious mistakes or losses...”
- Profession: Commercial banker
- “The determining trait of the **enterprising**...investor is his willingness to devote time and care to the selection of securities ...more attractive than average”
- Profession: Venture capitalist

Source: *The Intelligent Investor* (Harper & Row, 1973)

## Hypothesis: GAAP P&L too enterprising for Graham's Defensive Investor, too defensive for Enterprising Investor

Type:	Defensive:	Enterprising:
Profession:	Commercial banker	Venture capitalist
P&L:	Free cash flow	Economic Value Added
Adjustments:	Expenses investment in fixed, working capital.	Capitalizes intangibles and expenses non-cash cost of equity;
Output:	Reveals whether firm can self-fund	Shows whether firm creates value (i.e., WACC > COC)



## Case Study: Enron Corp.

- Per-share GAAP earnings up 9 of 10 years ending 2000
- During the '90s, total return 1,415% vs. 383% for S&P 500
- One of Fortune's "10 Stocks to Last the Decade" (August 2000)
- Board of directors rated among U.S.'s five best
- Andrew Fastow gets "best" award from CFO Magazine

## Step 1 of 3: Three Income Statements

Enron Corp. year ending Dec. 31, 2000 (millions except per-share)			
Income statement	Defensive (free cash flow)	GAAP	Enterprising (Economic Value Added)
Revenue	\$100,789	\$100,789	\$100,789
- COGS, SG&A, other	98,836	98,836	98,836
- <b>Investment fixed capital (#1)</b>	<b>3,555</b>	n/a	n/a
- <b>Investment working capital (#2)</b>	<b>1,071</b>	n/a	n/a
- <b>Intangibles (#3)</b>	0	0	<b>72</b>
- <b>Interest expense (#4)</b>	838	838	<b>2,609</b>
- Other	(1,093)	(215)	(55)
- Taxes	<u>684</u>	<u>434</u>	<u>765</u>
Total expenses	\$103,893	\$99,893	\$102,228
Profit (loss)	<b>\$(3,102)</b>	<b>\$896</b>	<b>\$(1,439)</b>

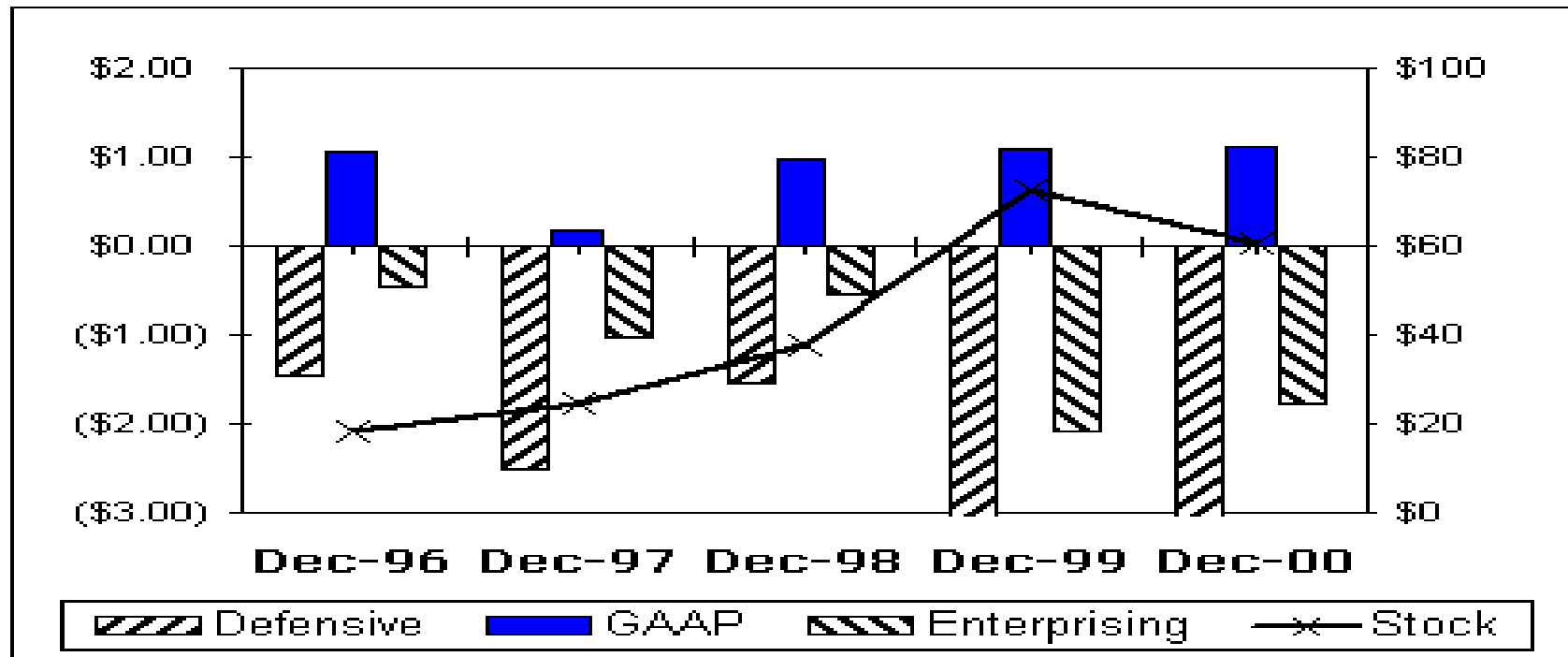
Source: Company reports, EarningsPower.com

## Step 2 of 3: Quality of Profits

ENRON (ENE)

Profit Per Share \$ (3 types)

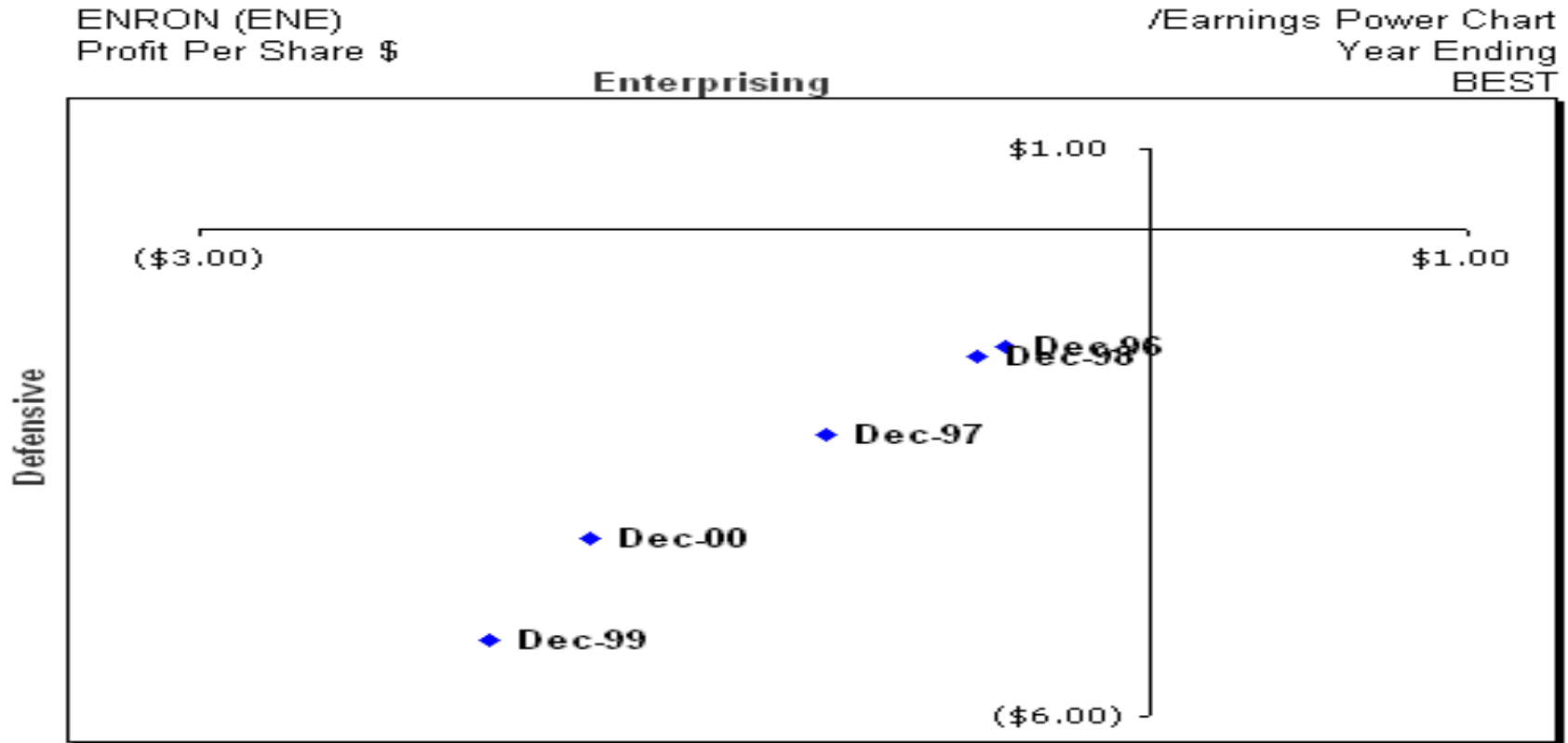
Quality of Profits  
Year Ending



Source: Reuters Knowledge; EarningsPower.com

Stock Price \$

# Step 3 of 3: Earnings Power Chart



WORST  
Source: Reuters Knowledge; EarningsPower.com

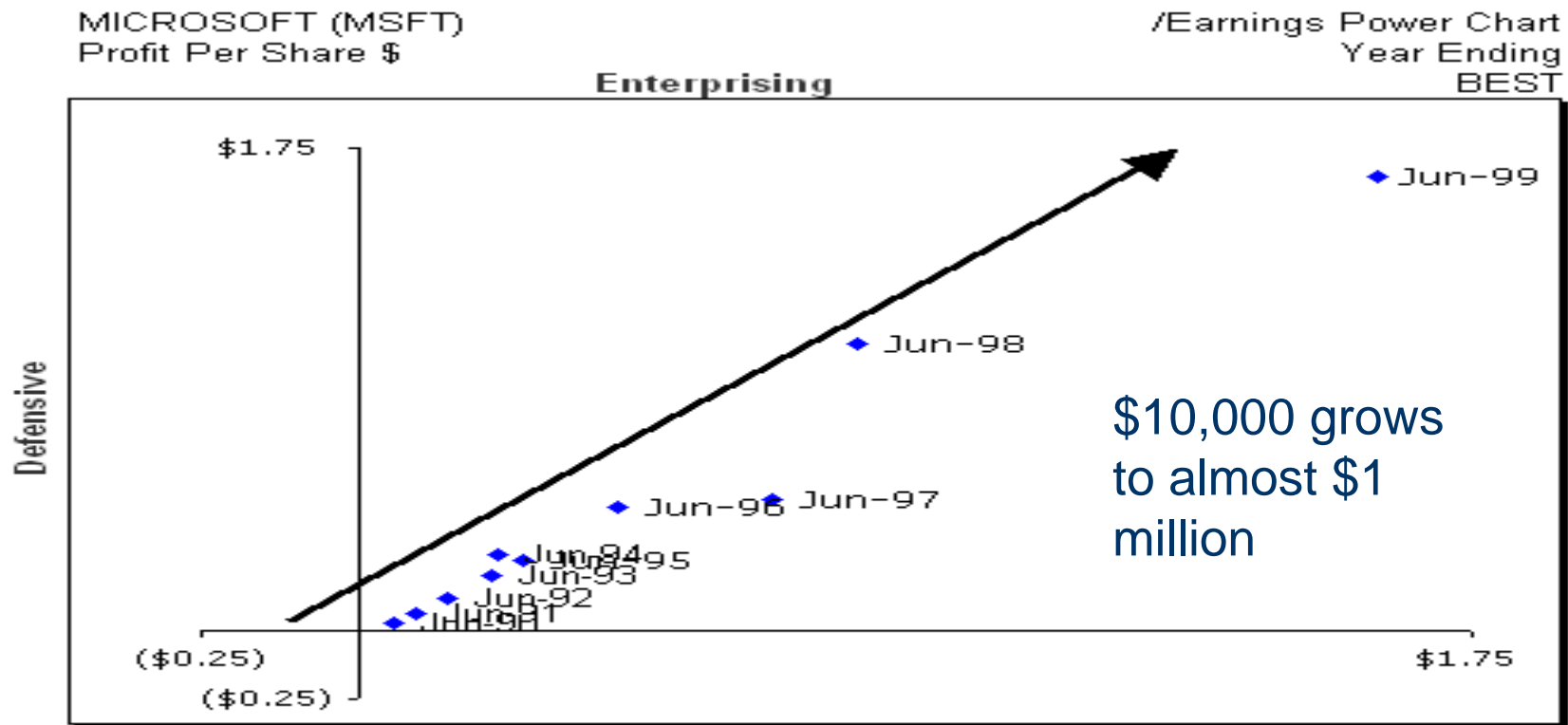
# Coal Mine Canary

Defensive:	Enterprising:	Both:
Autozone ('92-'99)	Bethlehem Steel ('96-'00)	Allou Health & Beauty ('98-'02)
Centennial Technologies ('93-'97)	Boston Market ('93-'97)	Bombay Company ('91-'94)
CML Group ('92-'97)	CKE Restaurants ('95-'97)	<b>Enron</b> ('96-'00)
EDS ('00-'02)	Crown Cork & Seal ('95-'00)	Polaroid ('95-'00)
Fine Host ('95-'96)	<b>HealthSouth</b> ('96-'01)	Sunbeam ('93-'98)
Gap, The ('96-'02)	Ikon Office ('93-'98)	Warnaco ('94-'99)
Gateway ('97-'01)	Rite-Aid ('95-'00)	Xerox ('96-'00)
<b>Krispy Kreme Donuts</b> ('02-'04)	Sherwin-Williams ('91-'00)	
Lucent Technologies ('97-'00)	WorldCom ('97-'01)	
Measurement Specialties ('98-'01)		
Tyco (3/00-12/01)		
United Airlines ('94-'01)		
Source: EarningsPower.com		



# **Hallmark of Profitable Growth: The Earnings Power Staircase**

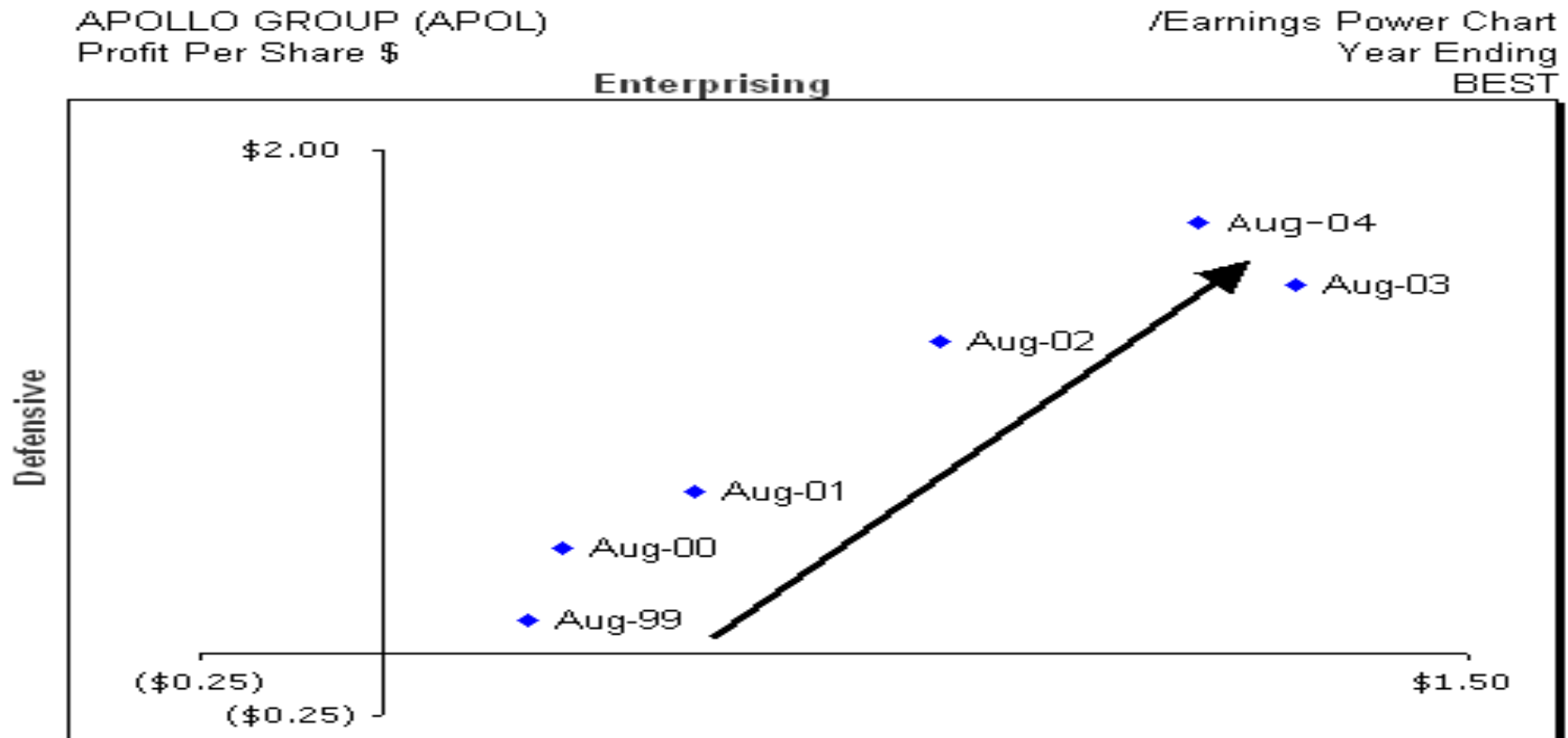
# Upper-Right Box: Microsoft ca. 1990's - Authentic Earnings Power and Earnings Power Staircase



WORST

Source: Reuters Knowledge; EarningsPower.com

# Apollo Group: \$10,000 grows to \$78,000



WORST

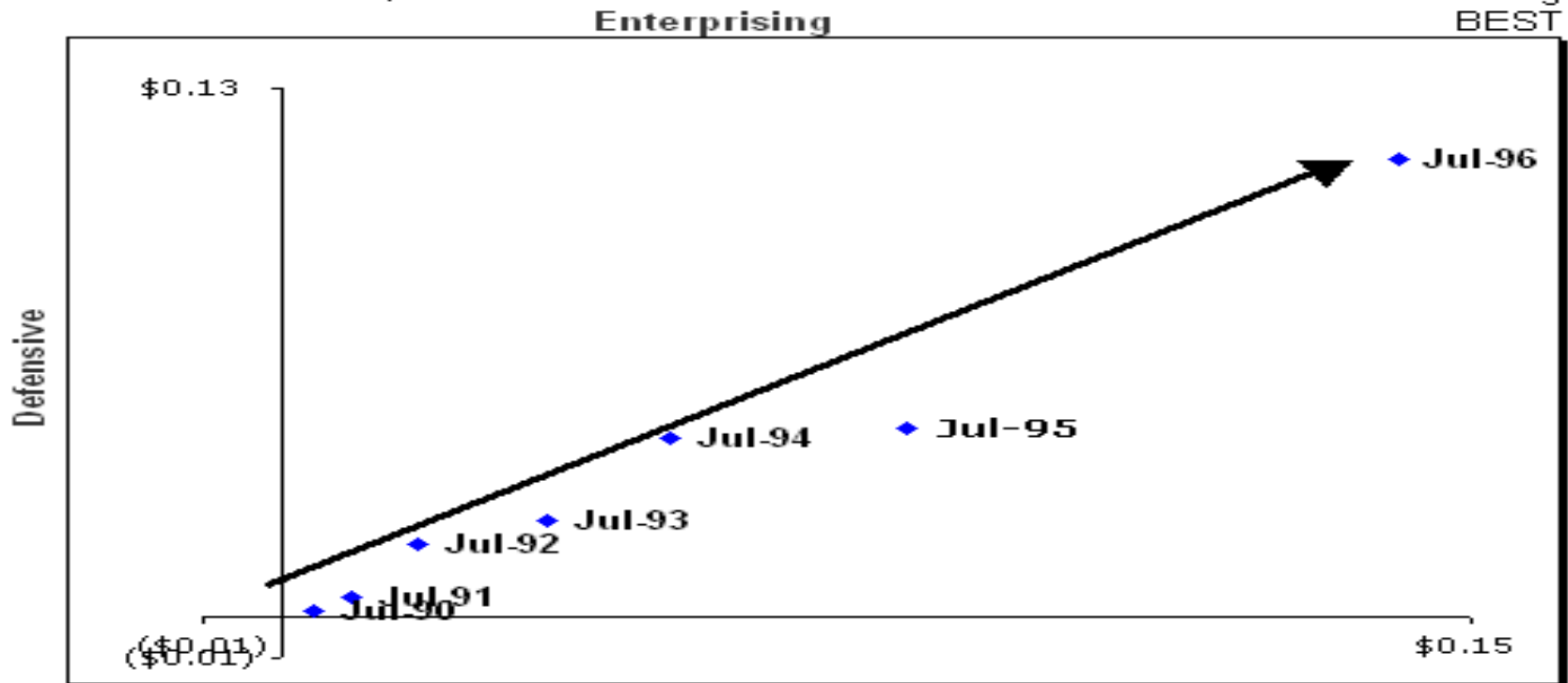
Source: Reuters Knowledge; EarningsPower.com



# Cisco Systems: \$10,000 grows to \$631,000

CISCO SYSTEMS (CSCO)  
Profit Per Share \$

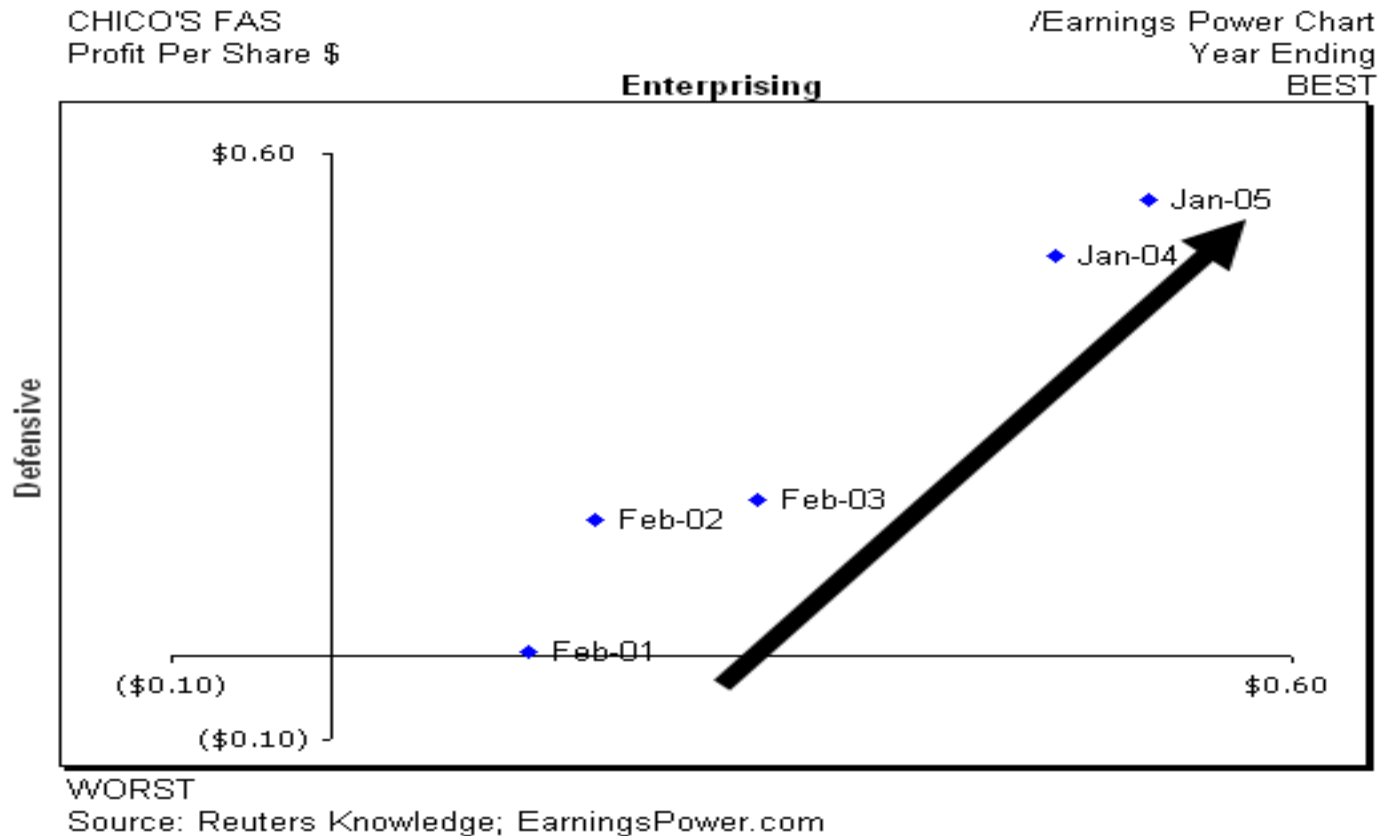
/Earnings Power Chart  
Year Ending  
BEST



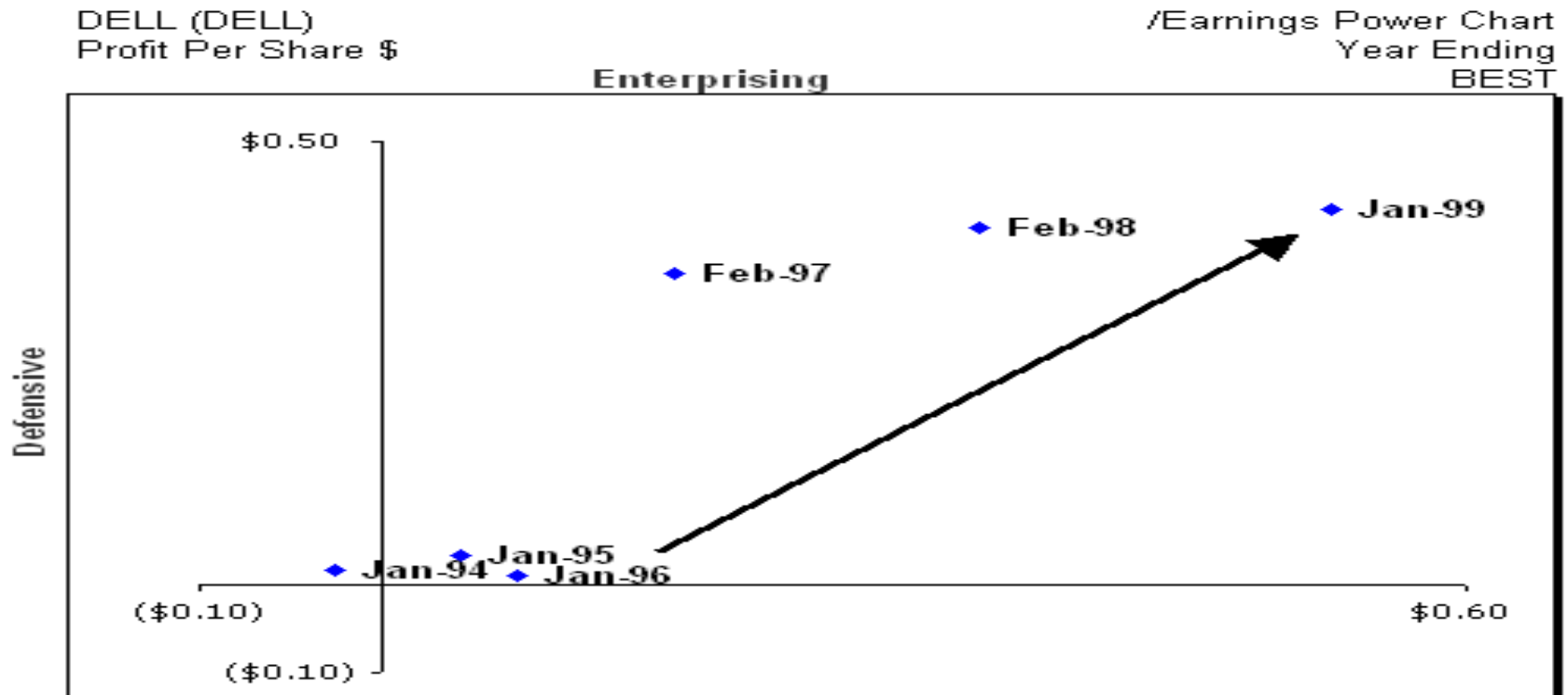
WORST

Source: Reuters Knowledge; EarningsPower.com

# Chico's FAS: \$10,000 grows to \$73,000



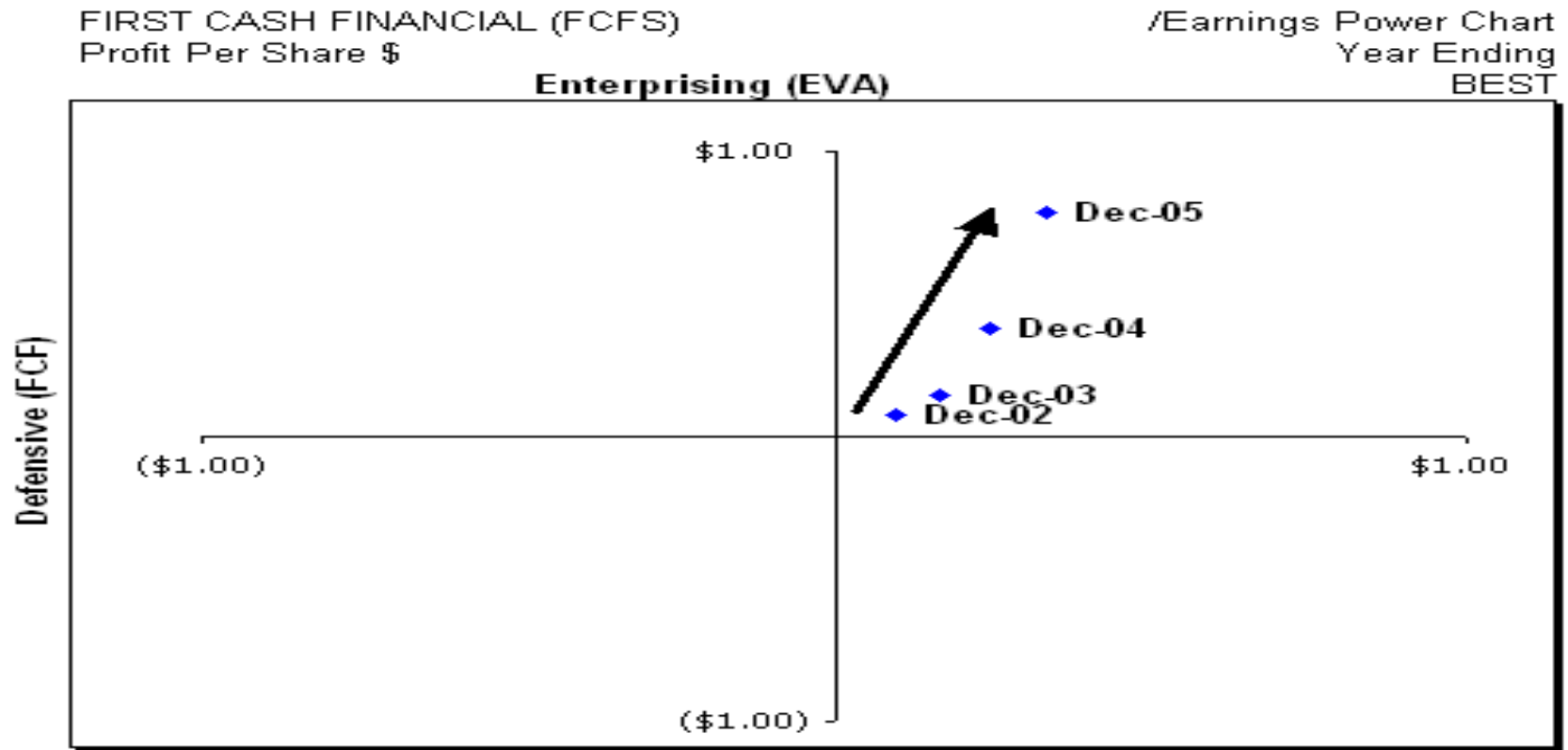
# Dell Computer: \$10,000 grows to \$1.3 million



WORST

Source: Reuters Knowledge; EarningsPower.com

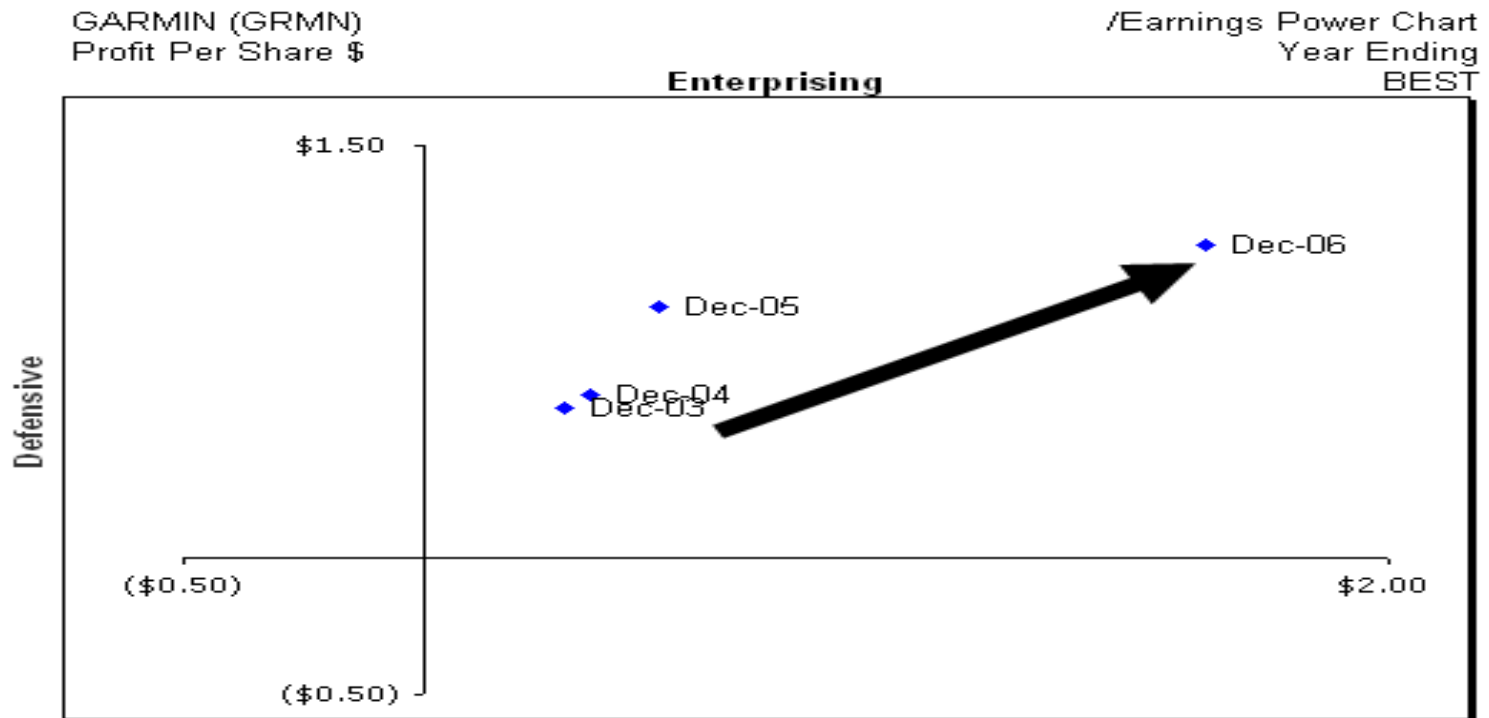
# First Cash Financial: \$10,000 grows to \$86,000



WORST

Source: Reuters Knowledge; EarningsPower.com

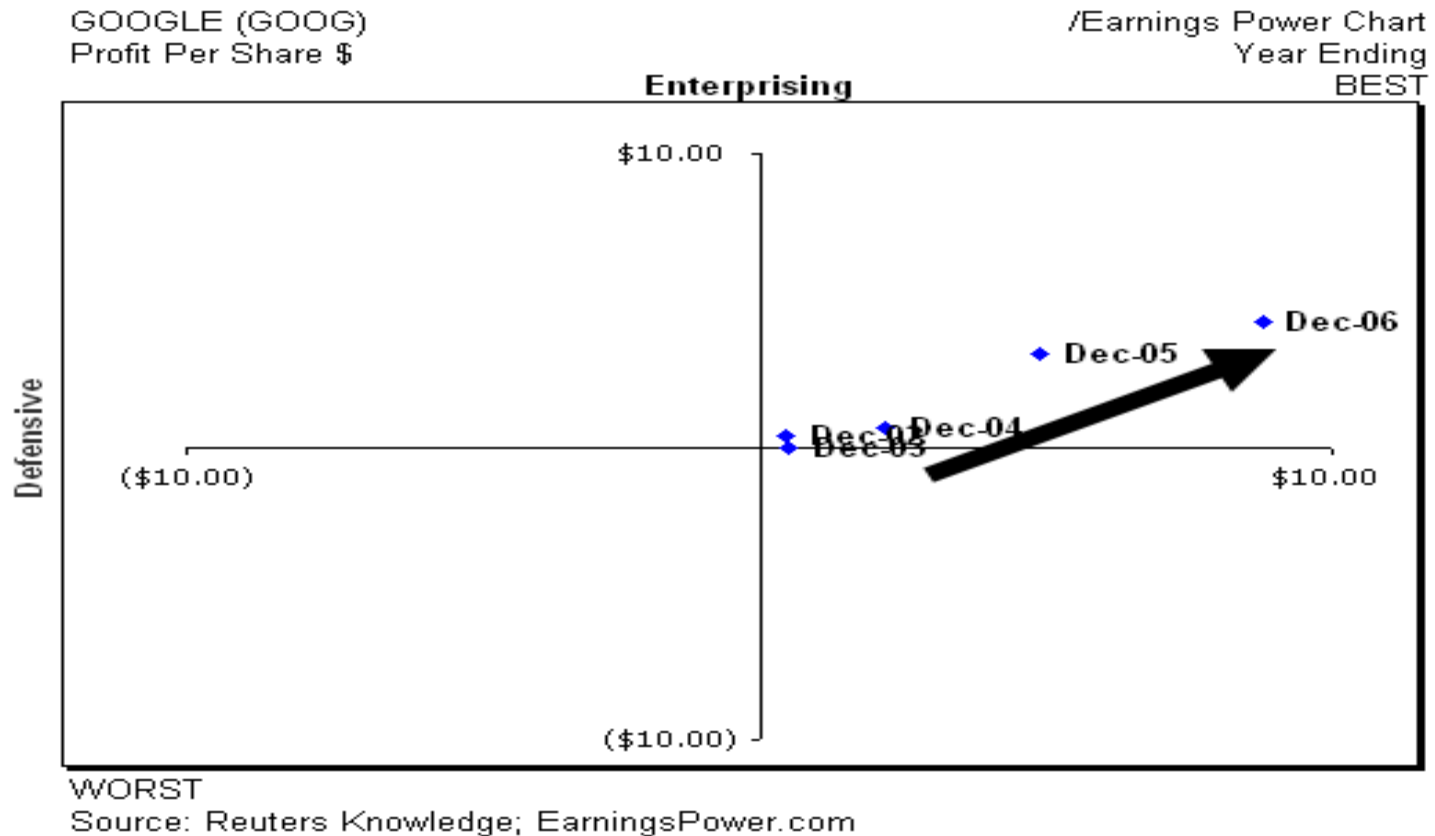
# Garmin: \$10,000 grows to \$44,000



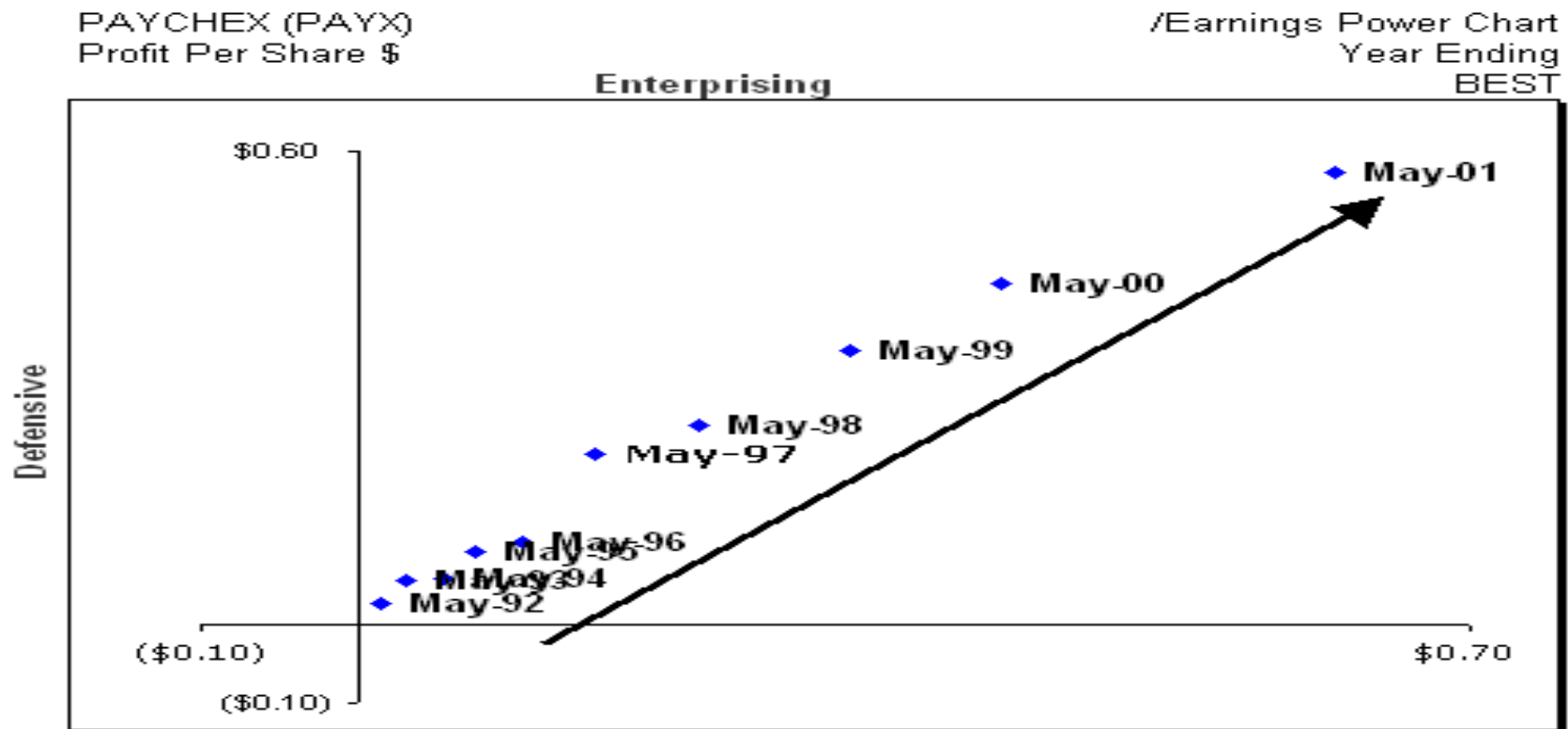
WORST

Source: Reuters Knowledge; EarningsPower.com

# Google: \$10,000 grows to \$51,000



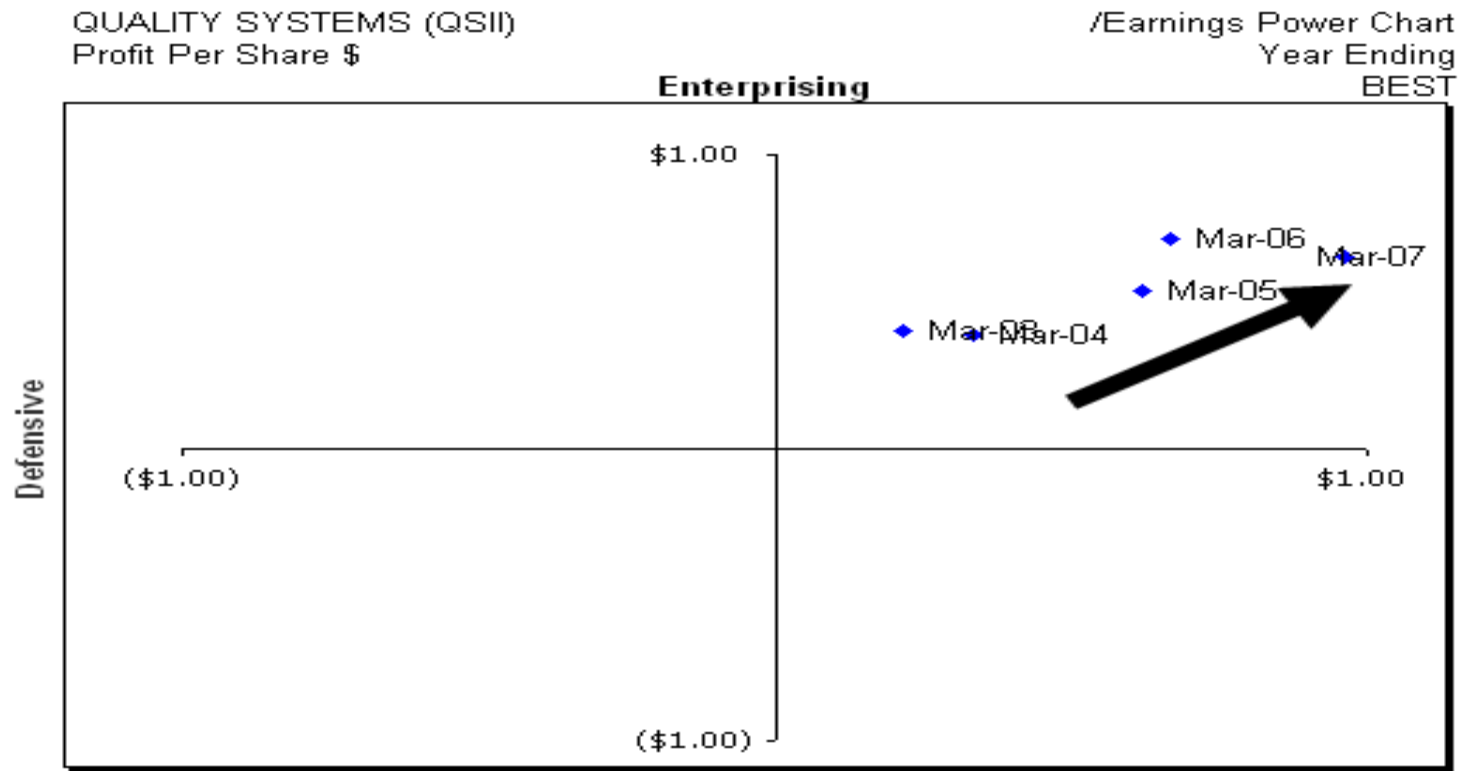
# Paychex: \$10,000 grows to \$257,000



WORST

Source: Reuters Knowledge; EarningsPower.com

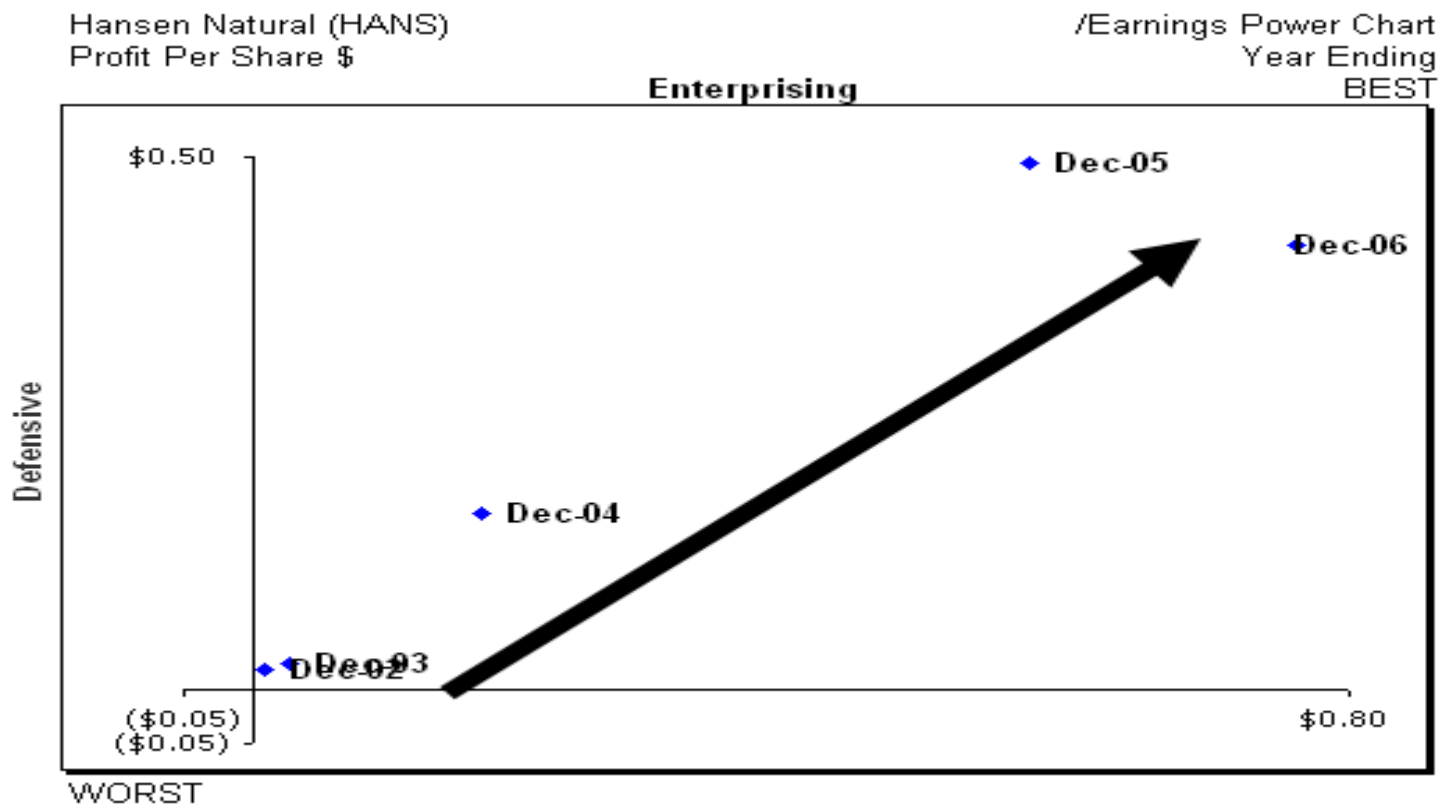
# Quality Systems: \$10,000 grows to \$70,000



Source: Reuters Knowledge; EarningsPower.com



# Hansen Natural: \$10,000 grows to \$2.6 million



Source: Reuters Knowledge; EarningsPower.com

## Six (6) Uses of the Earnings Power Chart

1. **Source new ideas.** “Long” prospects in upper-right box (or moving in upper-right direction); “short” candidates in lower-left box (or moving in lower-left direction).
2. **Monitor portfolio.** Which of 4 boxes are your companies in? Why? Are gains in GAAP confirmed by higher levels of defensive, enterprising profits? If not, why? Is there a tight or loose fit between GAAP and defensive, enterprising profits? What is long-term trend?
3. **Competitors.** If your company’s competitors are weakening, your company may be next.
4. **Customers.** See #3.
5. **Test management candor, realism.** Do they say they had “good year” but company moved in lower-left direction?
6. **Outlook.** Does strategy extend the Staircase? (i.e., profitable growth)

## Growth investor? Think “Earnings Power 1-2-3”



- Upper-right box?
- Staircase?

- Low-cost provider
- High switching cost
- Intangibles (e.g., brands, locations, patents, etc.)
- Network effect
- Ecosystem

- Fair worth?
- Key assumptions?
- Price-intrinsic value
- Reward-risk?
- Time-wtd. risk-adj. return?

**“Sorry, but I get 5-10 books or manuscripts a week. Wouldn't be able to run B-H if I read all (or a large part) of these.” - Warren Buffett**

June 30, 2003

Mr. Heurman - sorry, but  
I get 5 to 10 books or  
manuscripts a week. Wouldn't  
be able to run B-H if I  
read all (or a large part)  
of these -  
W Buffett

Dear Mr. Buffett:

I have just finished writing a book on common stocks and earnings power, to be published by McGraw-Hill. Would you be interested in reviewing the manuscript and, if you like it, write a brief (one- or two-sentence) endorsement for the backcover of *It's Earnings That Count*?

The book's purpose is to show how the four major limitations of the income statement found in every annual report, 10-K and 10-Q can lead otherwise knowledgeable investors to acquire



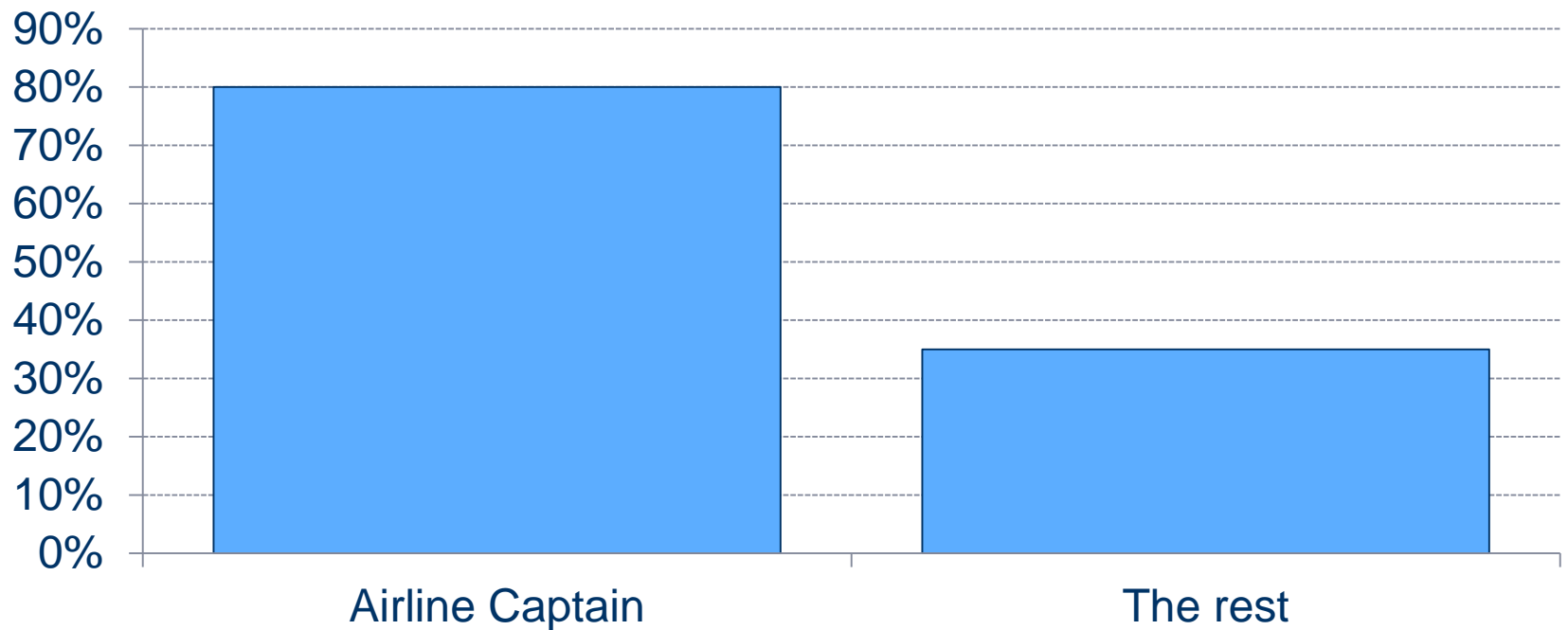
# **Book #2 - Checklist Investing**

## Active investing: It's Hard!

- Russell 3000 up 900% during 1983-2007
- 8,000 companies
- 64% underperformed
- 39% lost money
- 19% lost at least 75% of their value
- **25% accounted for 100% of the gains**
- Source: Longboard Asset Management, “The Capitalism Distribution”

# Freud's Sofa: Are You An "Airplane Captain"?

## Venture Capitalist IRR's by Personality Type



Source: Geoff Smart, PhD. [http://www.bigspeak.com/consulting/white-papers/Geoff-Smart\\_Horizontal-Human-Capita-Valuation.pdf](http://www.bigspeak.com/consulting/white-papers/Geoff-Smart_Horizontal-Human-Capita-Valuation.pdf)

## Tonight's Homework Assignment

- The Art and science of Human Capital Valuation (Geoff Smart, PhD.
- [http://www.bigspeak.com/consulting/white-papers/Geoff-Smart\\_Horizontal-Human-Capita-Valuation.pdf](http://www.bigspeak.com/consulting/white-papers/Geoff-Smart_Horizontal-Human-Capita-Valuation.pdf)
- Read pages 10-12 (best practices, worst practices)
- “There was a very clear link between an investor’s approach to human capital valuation and the overall deal success.”
- “There is plenty of room for private equity investors to gain competitive advantage and earn higher IRRs through using more effective human capital valuation practices.”



## Ownership (Equity *and* debt)

Type:	Questions/Comments:
1. Control	Trustworthy? Competent?
2. Incentives	Does everyone share same vision? Or are opposing forces ? (e.g., Founding family multi-generational outlook vs. impatient activist, or debtholders vs. stockholders)
3. Stability	Low turnover ownership helps management think long-term, high turnover encourages short-termism
4. Outlook	If ownership composition changes, why? Is outlook or reward-risk improving? Worsening?
5. Notable absence	Who doesn't own that should?

## Eight (8) Owner Types:

Type:	Comments:
1. Founder (inc. <b>founder-owner-operator</b> )	Teledyne's Henry Singleton, Wal-Mart's Sam Walton, Apple's Steve Jobs
2. Descendants & in-laws	Public, family-run co's had better financial performance during 1997-2009 than nonfamily businesses (Kachaner, Stalk, Bloch, HBR, Nov. 2012)
3. C-officers, directors & employees (non-founder)	If CEO owns more than 5% of co., the stock outperforms the market by 4.7% a year. If CEO owns more than 10%, then 8.8% average annual advantage (Lilienfeld-Toal and Reunzi). Also, CEO ownership of best co's of the 2000's was 20%; for co's that went bankrupt , 5%. (Source: ?)
4. Endowments & foundations:	Hershey Trust, Hormel Foundation, Carlsberg Foundation
5. Asset manager	Index, closet index, algo-quant, intrinsic value, activist, <b>smart money (billionaire)</b> .
6. Corporate	Yahoo (YHOO) owned 22.4% of Alibaba (BABA) at latter's 2014 IPO
7. State-owned enterprise	Gazprom, Petrobas, General Motors. Risk: Kleptocracy
8. Other (self-directed):	Do-it-your-selfers

## #1 of 2: Founder-Owner-Operator: Henry Singleton

- At U.S. Naval Academy ranked 1/820 in math
- Co-founded Teledyne, Inc. in 1960; for many years the conglomerate earned 50% on assets (definition: inventory plus fixed capital)
- Brilliant capital allocator. Bought 128 co's with high P/E-multiple stock. But after P/E fell, Singleton dismissed his acquisition team and never issued another share of stock. Between 1972-1984, in 8 separate tender offers, he repo'd 90% of Teledyne
- Big influence on Warren Buffett and Prem Watsa (Fairfax Financial)
- Co-managed President Reagan's blind trust
- More, William Thorndike's *The Outsiders*.
- Also, Leon Cooperman here: <http://videos.nyssa.org/a-case-study-in-financial-brilliance-dr-henry-e-singleton-of-teledyne-inc#sthash.jX8tljxi.dpuf>

## Finding Today's Founder-Owner-Operators

- Chris Mayer's Capital & Crisis and also Mayer's Special Situations (<http://agorafinancial.com/publication/fst/>)
- Horizon Kinetics ISE Wealth Indexes
- Virtus Wealth Masters Fund (VWMAX), which buys *owner*-operators (avg. 20% ownership) and eschews *agent*-operators (0.10% ownership). Defines agent-operator as an employee in an incentive structure that encourages “meeting shorter term, less fundamentally important financial targets, e.g., quarterly earnings estimates.” These people may view strategy “in the context of career risk as opposed to whether or not such decisions will prove accretive over the long term.”
- Morgan Dempsey Small/Micro-Cap Value (MITYX), which seeks “founder-owner-operator” cultures, which include at least 10% equity via after tax/open market purchases—not just options and/or SAR rights

## #2 of 2: Smart Money (Billionaire)

- “Large body of academic research that supports [Horizon Kinetics’ ISE] Wealth Index concept.
- e.g., Shulman and Noyes (2012) found an index of billionaire-led companies beat the S&P 500 Index by over 700 basis points annually during the period of study.
- More, [http://wealthindex.wpengine.com/wp-content/uploads/2014/06/Horizon-Kinetics-Wealth-Indexes-At-A-Glance-20140331\\_Added-Intl-Global-Asia-FINAL.pdf](http://wealthindex.wpengine.com/wp-content/uploads/2014/06/Horizon-Kinetics-Wealth-Indexes-At-A-Glance-20140331_Added-Intl-Global-Asia-FINAL.pdf)

## Pershing Square Holdings (PSH:NA)

- Smart money (Billionaire) CEO: Bill Ackman
- IPO: October 1, 2014 – “permanet capital”
- 2014 performance: 51% gross, 40% net
- Since 2004, Pershing Square, L.P. has compounded at 21%/year (despite approx. 1/3 AUM in cash, to meet redemptions). That’s \$13.9B of profit last nearly 11 years.
- Price: \$23.91; NAV: 25.97; P-NAV: 92% (1/6/15)
- Structure: closed-end fund
- Taxes: No entity level (Guenrsey)
- Influence: Typically, 1st or 2<sup>nd</sup>-largest shareholder, with board seat or substantial influence , “by virtue of our large stake and active voice.”
- Age: 48 (12/18/14): “I think I can do this for another thirty or more years and the good news is I really love what I do.”

## Summary:

- Nearly ruined by speculation, Ben Graham devised “margin of safety” strategy of buying co’s selling at two-thirds of net working capital after subtracting all liabilities. Then made 20% a year for two decades.
- If your thesis involves *growth* (secular, cyclical, prospective), use the Earnings Power 1-2-3 process as your margin of safety to help protect against miscalculation or bad luck
- Also, use a checklist to improve your problem-solving ability
- Lagniappe: e-mail me for ‘12 Tips for Impactful Writing’  
[Hewitt.Heiserman@EarningsPower.com](mailto:Hewitt.Heiserman@EarningsPower.com)
- Questions?

# Quiz: Height of Fenway's "Green Monster"





## Bio:

Hewitt Heiserman Jr. conceived the Earnings Power Chart, which is the subject of his book *It's Earnings That Count* (McGraw-Hill, 2004). Mr. Heiserman is a member of the Boston Security Analyst Society and CFA Institute. He has been quoted in TheStreet.com, The Wall Street Journal, BusinessWeek, CBS MarketWatch, Business 2.0, Better Investing, The Motley Fool, Complete Growth Investor, Barron's, and the Haverford Trust Company Adviser. Mr. Heiserman has spoken to the New York Society of Security Analysis, the Boston Security Analysts Society, Babson Investment Management Association, the American Association of Individual Investors, Fidelity Management & Research, Complete Growth Investor, Bryant College, Franklin-Templeton Group and VALUEx Berkshires on "Ben Graham and the Growth Investor." Mr. Heiserman graduated from Kenyon College with Distinction in History, and received the Faculty Award for Distinguished Achievement. Mr. Heiserman is an Eagle Scout, former vice-president of an open land foundation, and an Ironman Lake Placid finisher. Columbia University Press will publish his second book, *The Checklist Investor*, in 2016.

## notes:

	<b>Free Cash Flow</b>	<b>Economic Value Added</b>
Bona fides:	AAll price-FCF screen 20.4% annualized return 1999-9/30/14, vs. 10.% for all exchange listed stocks. (Source: AAll)	“Buy equally in today’s Top 25 Fortune 500 companies five years ago, you would have gotten a 23% total cumulative return. Buy Top 25 Most Profitable Growth companies, 174%. S&P 500 returned 10% during same period. (Source: Chris Barth, “The Most Profitable Growth Companies in the U.S., Forbes, Jan. 1, 2011)

<http://www.ft.com/cms/s/0/86d97610-00ab-11df-ae8d-00144feabdc0.html#axzz3lgB4neG4>