Checklist for Investments

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INTENT AND AUDIENCE

The intent of this document is to create a checklist for investments. The reason for the checklist is to create a rigor and process for evaluating companies and stocks against some laid out guidelines to prevent mistakes as much as possible.

The checklist itself is a summation of information gathered from multiple sources and individuals, books I have read combined with my own investing beliefs and past experiences primarily of mistakes.

The primary audience of this checklist is me, I would share it with my partners of Tapasya Investments and probably at some point in larger platforms such as twitter, YouTube , etc.

As I am writing this checklist I would first like to describe some key categories of this checklist so that whoever is reading this document is on the same page as I am on, in relation to the definitions.

Also another important point to consider is that almost no company will pass all the listed items within the checklist. That's where some subjectivity, experience or lack thereof would come into play to make the decision. Happy Reading!!

KEY CATEGORIES

As mentioned earlier, I have defined what each of the categories mean before they are included in the checklist so that we all start with a common understanding or at the least, the reader understands where I am coming from.

Risk: The likelihood of permanent loss of capital. This is different to how the street sometimes confuses this with volatility. The latter I would define as moves in the stock price regardless of the direction.

Circle of Competence: An understanding of businesses where one can confidently predict future cash flow with reasonable accuracy (all else being equal). This does not mean I have specifically worked in those businesses but when I review the annual report I understand the flow of numbers in the balance sheet, income statement , etc.

Opportunity Cost: The potential loss of 'gain' for not investing in a company due to another alternative chosen. Many ways to look at this, for example, not investing in Amazon in 2009 since capital is locked in an underperforming asset .

Patience: resisting the natural human bias for action. Taxes and transactional costs significantly impact returns. Never take an action for its own sake.

Other Qualitative and Quantitative Metrics: These are self-explanatory but basically qualitative metrics such as Management Integrity, Employee Satisfaction, Customer Stickiness and Quantitative metrics such as revenue growth, cash flows, ROCE , etc. More on all this as we review the checklist.

Thanks for hanging in there!! Most individuals generally ask for this one magical metric (usually its PE - Price to Earnings ratio) to determine whether one should make the investment. I wish it was that easy!!

CHECKLIST

1) RISK

- ***Incorporation of an appropriate margin of safety***
    - For this computation I would compute the intrinsic value of the company based on historical cash flows and assume/predict future cash flows.
- ***Business models susceptibility to high inflation and interest rates***
    - Usually evaluated by multiple things which include the type of product the company sells and whether its discretionary e.g. TVs , etc. Many other attributes such as available cash, debt, past performance during inflationary periods, pricing power , etc.
- ***Potential for permanent loss in capital***
    - To pursue high returns, the investments at times have to be made in companies that may not be producing positive cash flows but have high revenue growth rates , etc. In this case 2 things are considered to be most critical. The price being paid (and I have guardrails for the same to not

overpay) and portfolio sizing — typically will not be more than 2%-3% of the portfolio.

2) CIRCLE OF COMPETENCE

- ***Is this a business I can understand***

    - The intent here is not having prior work experience within the industry but being able to read through the annual report (one of my most important sources for information) and understand it. Being able to understand the flow of numbers in the Income statement, cash flow statement , etc., and having a reasonable ability to project future cash flows (approx.)

- ***Avoid businesses that are in a secular downtrend***

    - There are some businesses that are in a secular downtrend with no end in sight of change e.g. Department stores in Retail. Basically completely avoid these businesses though Retail is one of the businesses I understand very well. Does not mean there would not be any mis-priced opportunities to take advantage of but those would be exceptions.

- ***Durable competitive advantage***

    - Made famous also as economic moat, how easy is it for existing or new competitors to steal market share. Few examples here, Apple where once you are in the ecosystem it's hard to switch. I personally don't know anyone who has. Hi-tech companies which I avoid. I am a technologist and have been a programmer/coder for a long time. I think all companies that would need to survive over the long term need to embrace technology. The ones I avoid are generally software companies and the reason is ease of disruption here. An example here is where a friend of mine along with a colleague are thinking of creating a product that disrupts or competes with Shopify. Whether they are successful or not, the very fact that someone with minimal capital and who is sane can think that way; I would just exclude that business from investing. Too much change for my taste.

- ***Businesses to completely avoid***

  - There are some businesses like the one listed above that I completely avoid. This is a subjective list and each individual needs to come up with their own list

    - Auto (I missed Tesla because of that and still do!), Hi-Tech, Airlines, Energy , etc. This is not an exhaustive list mentioned here.

3) PATIENCE

- This is the art of resisting the bias to act.

- Evaluate a new idea against one's existing portfolio. Which one would I replace as opposed to just adding a new position; Need a compelling reason?

- Consider all costs (taxes, transactional , etc.); taxes are the biggest costs here typically.

4) MANAGEMENT TEAMS

- CEO and Direct report team, understand how long they have been with the company and together. This may sound creepy but I look many of them up on social media to see anything out of the ordinary.

- I look for diversity, personally I think it's important. This could be color, gender, sexual orientation , etc.

- Board - here I briefly look at it; usually on the investor relations website. Generally believe most (if not all) boards provide little to no value. Hence this is just for more informational purposes.

5) METRICS

- This is a hard one since I look at many pieces of data. Hence again this list is not exhaustive.

- Revenue growth, Cash flow growth (or improvement if negative), Return on Capital (prefer over ROE), Gross Margin (percentage), Debt, Net Income ($'s).

- As mentioned there are many more I look at but the filter criteria for me is the company needs to be showing Revenue growth, cash flow growth, high gross margin % (Exception Costco).

- Stock dilution i.e. if the number of outstanding shares are continually increasing. Many reasons for this such as companies want to raise capital, employee stock options , etc. The latter which I have been a beneficiary of. Buy-backs can offset the latter.

- Typically look at these metrics over time, 1 year, 3 years, 5 years and 7 years.

6) CAPITAL ALLOCATION

- This in my opinion is one of the most important factors that determine long term success of a company. This in my opinion is true for companies or individuals/households.

- Keeping with the investment theme here, how does the company allocate excess cash i.e. investing in growing the business, buy-backs or dividends. I like them in the order I have stated.

- Many of the metrics in the above section (some mentioned and some not) throw light on this.

APPENDIX

Some of the sources used came from oldachoolvalue.com where the writer has consolidated information from multiple websites.

1) An Investing Principles Checklist - from Poor Charlie's Almanack (it's also my favorite book)

2) Ben Graham's 10 Rules for Selecting Stocks

3) Checklist from Philip Fisher

4) Checklist from Mohnish Pabrai (shared during a talk at Columbia University)