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Investment Methodology

At Lowell, Blake & Associates, we have always believed in long-term investing and the idea that, in order to have that focus, it is necessary to take in all the demographic, social, and economic shifts occurring around us. Accordingly, there are a number of ways in which we find investment ideas, aside from those generated internally, specifically, colleagues, clients, and our Investment Committee, to name a few. Barring those sources, the following is our general top-down, bottom-up approach for how we identify potential investments.

1. Identify developing and ongoing trends and themes
    a. Gather data to establish longevity and strength
2. Identify industries that fall under these trends or themes
3. Gather relevant companies and run a comparative analysis on valuation, financial strength, growth trajectory, and qualitative factors (See 'Analytical Markers')
4. Determine how the stock or stocks will fit into client portfolios
5. Team decides whether or not to incorporate company into portfolios

Analytical Markers

There are a number of key markers that we use in analyzing stocks. The purpose of this memo is to highlight the most important of them in each of three principal categories: balance sheet, income account, and vital relationships.

Balance Sheet

A. Debt

We start with the balance sheet because it is particularly valuable as a screening device. A company with a poor one rarely, if ever, can qualify as a suitable holding for a fiduciary. We particularly dislike heavy debt, which we view as a severe competitive handicap, especially in a weak economic environment. To determine what "heavy debt" is, we carefully analyze the characteristics of a company's debts, in particular, the structure, interest characteristics (fixed or floating rate), maturity dates, and covenants. Then we calculate liquidity and solvency ratios and compare them to those of peer companies. The primary goal is to determine suitability of a company's capital structure, acknowledging that each industry and company have differing needs for debt.

B. Goodwill

Goodwill is an element that we tend to dislike because it is an intangible accounting entry, reflecting the excess of the purchase price over the value of assets acquired. It may not be an asset at all, and yet, it frequently represents a major portion of a company's stated book value.

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Management is required to write off acquisition-related intangibles when it determines that carrying values may not be recoverable, thereby causing an abrupt and possibly substantial reduction in shareholder's equity. With that said, we acknowledge that companies, according to industry, will have differing levels of goodwill. For example, a smaller company may need to acquire to grow its business. Thus, we examine acquisition strategy and the purchase prices paid before excluding a company from investment for having high amounts of goodwill.

C. Working Capital Sufficiency

The ability for a firm to cover its working capital needs is a strong indicator of financial health and its ability to safely cover dividend payments. Companies that exhibit strong levels of net working capital tend to have high levels of cash and 'equivalents' (marketable securities, etc.) and limited current liabilities (defined as liabilities due within one year). We must also acknowledge that certain firms, which are financially healthy, can exhibit negative working capital. Examples include large consumer staples companies that are able to quickly turn over inventory, collect receivables, and, simultaneously, extend payment terms with suppliers. These types of firms have what is called a low 'cash conversion cycle'. Conversely, companies with long cash conversion cycles, such as those that manufacture and sell capital goods, must have high amounts of cash and equivalents in order to satisfy current liabilities before turning over inventory and collecting on receivables.

D. Plant and Equipment

Companies with high levels of plant and equipment, such as manufacturing firms, typically exhibit equally large levels of investment. The balance sheet accounts must be carefully analyzed to determine when large outlays of capital may be required. Depreciation and property, plant, and equipment accounts can be analyzed for indications as to future outlays. Such clues give us insight into future cash flows and dividend policy.

E. Common Shares Outstanding

Changes in the number of shares outstanding are important for their impact on per share results, and thus, the economic value available to existing shareholders. A stock buyback program can both enhance earnings per share and provide support for the stock price. However, the success of any such program depends on the source of the funds used and prices paid. We generally disapprove of the use of debt to buy back stock, and paying prices that represent what we believe to be exorbitant, relative to fair value.

Another important topic relates to stock option plans. When used improperly, these plans can dilute shareholder equity and tempt senior management to put their self-interests ahead of those of the company and its shareholders. We favor stock option plans that represent no more than 5% of outstanding shares, are disseminated as widely as possible among employees, and are exercisable at 100% of the stock price at the time of grant. We disapprove of companies that repeatedly reduce the exercise price as the stock price declines, and fail to count grants as an expense in the income statement.

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Income Statement & Cash Flows

Unlike a balance sheet, which provides a financial picture as of a specific date, the income statement covers a period of time, such as three months or a year. Thus, we pay a lot of attention to trends and whether they are accelerating or decelerating. Particularly noteworthy is the change in the direction of a trend, because that can be extremely rewarding for those who detect it and act on it at an early stage. Taken by itself, a company's performance tells only part of the story. The real test is how its results compare with those of its competitors and others in similar businesses. It is critical, for example, to know whether a company is gaining or losing market share. If one company's experience in sales and profitability is significantly inferior or superior to that of its peers, we have some indication of the opportunity or vulnerability it faces

A. Sales

Sales are obviously the lifeblood of any enterprise. They are made up of three principal elements, physical volume, sales mix, and selling price. To the extent possible, we try to determine the contribution of each of these elements, since sales gains from price inflation are fundamentally less creditable than those from physical volume. The short-term impact on profits may be as good or even better, but the sustainability of growth through significant price increases is ultimately questionable. Currency can also play a role in the reported sales figures. When possible, we exclude currency impacts to get a true picture of the business performance.

B. Gross Margin & Operating Margin

The gross margin and operating margin are simply measures of the relationships between production costs and total operating costs (including selling, administration, R&D expense, etc.) and sales. They are a good measure of how well management is running the business, both absolutely, and relative to competitors. Care needs to be taken when comparing figures between different companies, as accounting methodologies can differ significantly.

C. Taxes

The tax rate needs to be calculated to determine whether earnings over the short term are being temporarily inflated or penalized by a non-recurring tax factor.

D. Cash from Operations

Cash from operations, also known simply as cash flow, is a reconciliation of cash and non-cash charges, which give an accurate portrayal of the cash generated/used by a business' operations during any given period. Cash flow is the amount the business is generating for management to reinvest, service debt, and/or pay out dividends. It is incredibly useful in appraising a company's ability to provide for its own capital requirements, without resorting to excessive use of outside capital (borrowing or sale of additional stock). Careful analysis of a company's cash flow statement is crucial, as it is less susceptible to management judgement and manipulation, and it provides a basis for many modern valuation methodologies.

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Key Relationships

A. Return on Capital

Return on capital employed in the business is the most revealing measure of the worth of any enterprise. This single relationship tells us a great deal about a company's ability to compete, to pay dividends, and to meet its future needs for capital. As always, we are interested not only in just the figure itself but, most important, whether it is improving or deteriorating and how it compares with others in similar businesses.

Taking that a step further, is the return on capital after dividends have been paid. This is a fundamental measure of a company's ability to grow without bringing in additional capital. However, this indicator is valid only if the company is able to earn a return above its cost of existing capital. If a company is unable to earn above its cost of capital, it should pay out the majority of its earnings via dividends. The calculation of a firm's cost of capital is largely subjective and relative to the overall economic environment.

B. Debt Service

The amount of cash flow committed to debt service and required for expenditures on plant and equipment is obviously important, because what is left, known as free cash flow, is the prime measure of dividend paying ability. Free cash flow is also a measure of management's flexibility in taking advantage of opportunities, which may arise unexpectedly, such as an acquisition or a chance to buy back stock at an attractive price. These issues bring us back to our aversion to heavy debt expressed at the outset. At the very least, debt represents a management constraint and resultant competitive disadvantage compared to a debt-free company. If the returns contemplated when the debt was incurred fail to materialize, a company's ability to pay dividends and ultimately even its survival may come into question.

Qualitative factors

A. Management

Having touched on quantitative points and relationships, we should also cover a few vital qualitative considerations. Foremost among these is the integrity and capability of management. Integrity is intangible, but is evident from treatment of employees and customers, relations with communities in which a company operates, concern for the environment, etc. It is also evident in the transparency of a company's accounting, as manifested in footnotes to the financial statements, which can vary tremendously in clarity and detail. We look at how sales are recorded, whether non-cash accounting credits and/or non-recurring gains are included in reported earnings, whether there are frequently recurring "non-recurring" charges, etc. Accounting rules are complex and subject to interpretation, but opportunistic accounting practices are pretty obvious. To appraise capability, we look at how management treats the balance sheet, utilizes cash flow, responds to changing competitive conditions, and controls costs (the trend in sales per employee being a useful statistical marker).

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B. Other

The advent of new technologies has allowed us to gather representative samples of important, non-financial information. Primary examples include employee morale and perceived product quality. These factors are difficult to quantify in a consistent manner and come from many different sources, yet we find it important to support traditional financial statement analysis with an analysis of qualitative measures not found in a quarterly or annual report.

Conclusion

The valuation aspect of investment decision making is ultimately subjective and deserves greater elaboration than we give here. Clearly, investors are prone to following herd instincts, and to carrying both optimism and pessimism to extremes. We accordingly are careful not to chase stocks when they are simply in vogue. Nor are we willing to sell stocks of good companies when they fall out of favor, except for tax reasons, or in cases where there has been a significant change in the basic outlook for the business. Thus, we are contrarian in approach, based on the conviction that a discipline of buying low and selling high is the surest approach to consistent and strong investment performance.

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