How the best hedge funds invest.

High-performing, long-term investors often share a similar philosophy and process. We explain both.

(8 min read)

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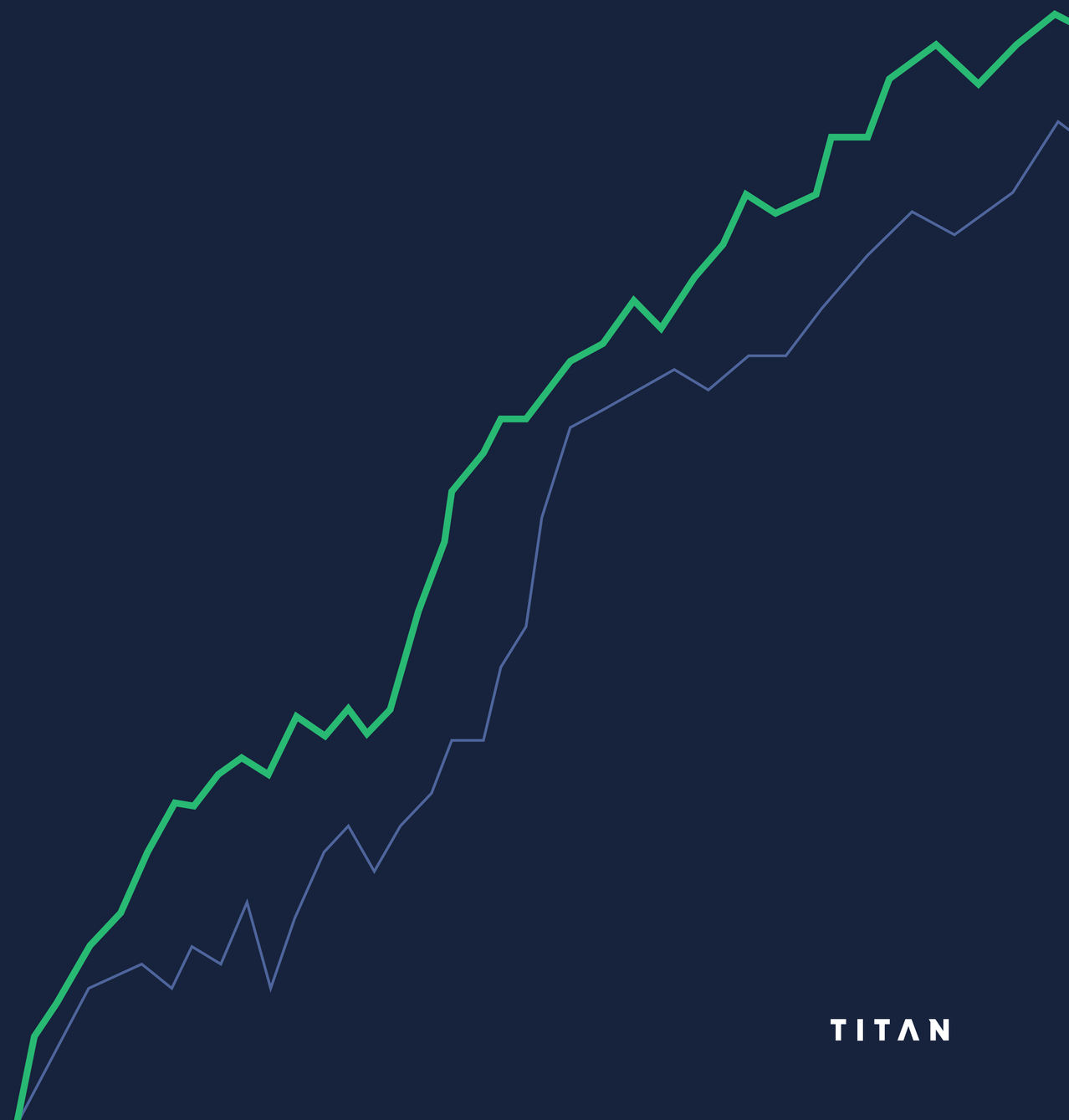

TITAN

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Quality is more important than quantity. One home run is much better than two doubles.

STEVE JOBS

You should want home run investments. “Quality” investments tend to be home runs.

30-SECOND SUMMARY (2 OF 2)

All great long-term investors have a unifying philosophy behind their investment process. One of the most successful philosophies is called quality investing.

The goal is simple: find quality businesses at attractive prices.

Quality businesses don't often become available at attractive prices. But when you find one, hold on tight. You can ride these for a long time.

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Let’s break this down into three things.

1

All great investors have a unifying philosophy. One of the most successful is called quality investing.

PHILOSOPHY

What is Quality Investing?

Simply put, quality investing is the art of finding a portfolio of high-quality businesses that you can hold for the long term.

The idea is that these businesses are the best positioned to compound your capital with high risk-adjusted returns.

Note: This is the opposite of trying to day trade.

PHILOSOPHY

Quality businesses tend to share the same fundamental characteristics.

Wide moat

Hard to replicate, even if you had a $1B budget. Network effects are a good example.

Strong cash generation

Cash flow is king. It's the true measure of a business' profitability.

High returns on capital

For every $1 the business invests, it generates significantly more over time

Excellent management

High integrity, strong executors, reliable guardians of capital

Good growth prospects

There's a clear and long runway for growth. Maybe even a megatrend.

PHILOSOPHY

A wide moat is one of the most important. Moats come in all shapes and sizes.

ECONOMIES OF SCALE
BRAND VALUE
SWITCHING COSTS
NETWORK EFFECTS
PATENTS
CULTURE

PHILOSOPHY

A wide moat is one of the most important. Moats come in all shapes and sizes.

ECONOMIES OF SCALE

amazon.com

Amazon benefits from the “flywheel effect.” The more customers they sell to, the more utilized their distribution centers become. This lowers their unit costs and improves their ability to lower prices, which brings in more customers - thus keeping their “flywheel” turning and turning...

PHILOSOPHY

A wide moat is one of the most important. Moats come in all shapes and sizes.

NETFLIX

Culture enables companies to attract top talent and have high-performing teams. Netflix has one of the best. Netflix isn't certain what its business will look like down the road (expanding into gaming?), but their strong culture enables investors to say "if I give them my money, they'll figure it out."

CULTURE

PHILOSOPHY

This is just a little taste of Quality Investing. It might sound like two investing terms you may be familiar with.

Growth Investing

Finding companies that exhibit above-average growth prospects even if their stock prices appear expensive. Popular today.

Value Investing

Finding companies whose prices are below their intrinsic values, irrespective of growth prospects. What Buffett is known for.

2

Examples of quality businesses are sometimes in plain sight. You can find one at the bar.

AN EXAMPLE

Meet Constellation Brands, the producer of Corona.

TICKER: STZ

AN EXAMPLE

Constellation has a portfolio of 80+ consumer brands across beer, wines, and spirits.

TICKER: STZ

It is the #1 multi-category supplier of alcoholic beverages in the US.

AN EXAMPLE

But what is the essence of Constellation?

It takes commodities that anyone can buy, such as wheat and hops...

...mixes them together into a glass bottle...

...and sells them at a massive premium.

TICKER: STZ

“

Buy commodities, sell brands has long been a formula for business success. When we bought See's Candies, we didn't know the power of a good brand.

WARREN BUFFETT

AN EXAMPLE

To sell a brand, you need distribution. You need to be able to get it on the store shelf.

This is one of STZ's strongest moats.

The US beer industry is highly concentrated, sitting in the hands of essentially 11 brewers. This means this group controls most shelf space nationwide.

Distribution is very sticky. Changing the inventory and delivery logistics can cause massive headaches for wholesalers. So they tend to just stick with brands that have worked in the past.

Consumers also tend to establish local preferences, making it less ideal for wholesalers to swap out brands and risk losing those customers. This stickiness creates a high barrier to entry for new entrants, benefitting the scaled incumbents like Constellation.

THE PUNCHLINE

Constellation Brands can easily launch new beer brands into its massive distribution web, which is incredibly difficult for smaller brewers to replicate.

AN EXAMPLE

Let’s put Constellation through our checklist.

✓	**Wide moat**	Lasting brand value and difficult-to-replicate distribution channels
DISCUSSED		
✓	**Strong cash generation**	Pricing power from premiumization strategy supports free cash flow
✓	**High returns on capital**	Returns on tangible capital are around 25%, which is tremendous for beverages
✓	**Excellent management**	Family-run business and history of strong execution
✓	**Good growth prospects**	Consistently grows sales at above-GDP rates even through difficult recessions

AN EXAMPLE

Constellation? Check.

What about Google? (Yes)

or Best Buy? (Hmm)

or Uber? (Likely)

Check out our blog for more examples of quality businesses.

JUMP TO THE BLOG

3

So how does one find these gems? Great investors implement rigorous analytical processes - and we mean rigorous.

THE PROCESS

A process is a systematic way of assessing any investment. The best processes form a mosaic.

STEP 1: IDEA GENERATION

Inspiration comes from many places. Existing expertise, company news, other investors, and often sheer intellectual curiosity. "Would you be willing to pay more for Netflix?"

STEP 2: COMPANY RESEARCH

The best investors form a mosaic. They seek to become the smartest person on an investment by analyzing the company through every lens imaginable.

- Read several years worth of historical financial filings
- Meet with management and employees. Grill them (nicely)
- Build a detailed financial model
- Use the company's product / service (if possible)
- Repeat all the above for the company's competitors, suppliers, and customers (i.e., to understand Spotify you need to know Apple)
- Understand market perception to find a variant view ("People are under-appreciating that Netflix could raise pricing with minimal churn.")

STEP 3: VALUATION

How much should you be willing to pay for this business?

STEP 2: COMPANY RESEARCH

An investor can build conviction around the business' quality by answering several fundamental questions.

What is the essence of this company?

How does this company make money?

Who buys this company's product or service?

What are the unit economics? Are they improving?

What is the company's competitive positioning relative to peers?

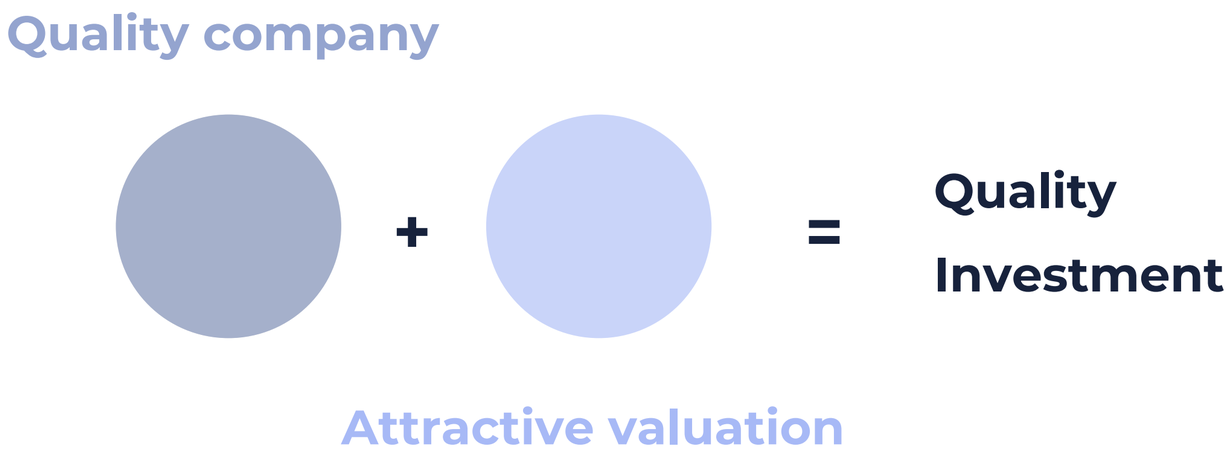
How is the company capitalized? What are the key trends in its financials?

What are the core drivers of the company's future prospects? Do you have an ability to forecast them?

Checklist begins to populate and an investment thesis emerges.

STEP 3: VALUATION

Once you form a thesis on the business, the next question is how much you should pay for it.



STEP 3: VALUATION

Not every quality business is a quality investment. The price you pay is important.

ANNUALIZED 5YR RETURNS

Coca-Cola

5%

S&P 500

13%

Annualized 5YR Total Shareholder Returns as of 6/15/18

STEP 3: VALUATION

Investors typically estimate a company's intrinsic value using several methodologies.

	Insight	Example
Calculating future cash flows	Can make direct assumptions about future business drivers	“I believe Facebook can raise pricing on Instagram ads.”
Comparable peers’ valuation	Can observe how the business is priced vs. competitors	“It’s trading slightly north of other large cap tech companies.”
Historical valuations	Can observe if current price is attractive vs. the past	“Because of the data breach, this is the cheapest it’s been in years.”
Private buyer valuation	Enables one to think like a long-term owner	“If I could acquire its tech, people, and platforms, I'd pay 2x.”

Is the current price a significant discount to intrinsic value?

How certain am I of the drivers that will close this discount?

Attractive valuation

STEP 3: VALUATION

Quality companies are usually more expensive. But they usually aren't more expensive enough.

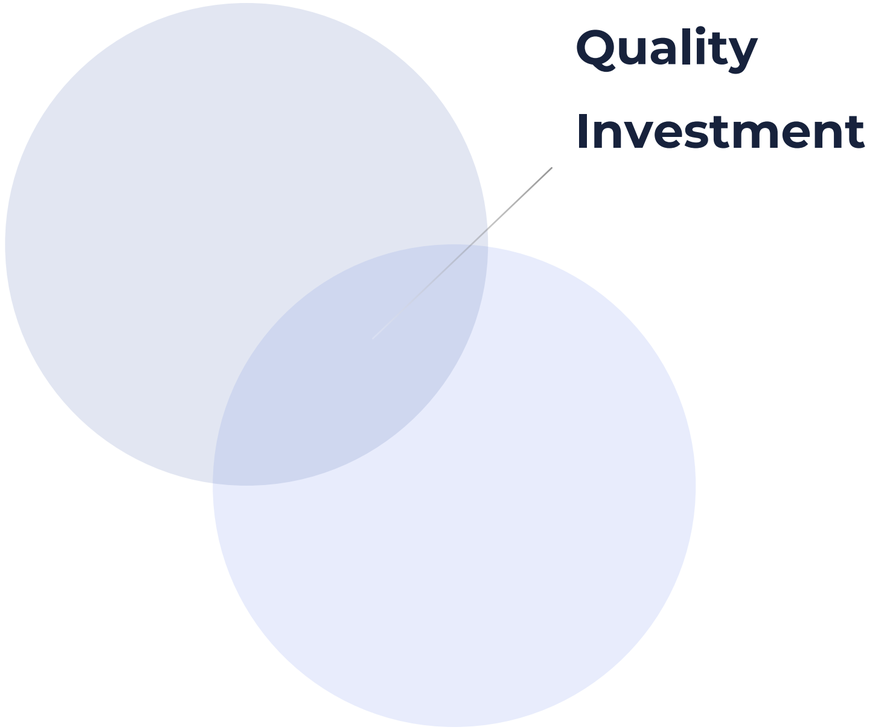
"

While premiums are paid for shares of such [quality] businesses, they are frequently **insufficient**. Valuation premiums of quality companies often reflect some degree of expected operational outperformance, but actual performance tends to exceed expectations over time.

QUALITY INVESTING
CUNNINGHAM, EIDE, HARGREAVES

THE PROCESS

When you find a wonderful business at an attractive price, then it's go time. But this takes a lot of patience.



THE PROCESS

Good investing is very similar to surfing. You spend 95% of the time waiting for waves.

Even if a quality business is found, a research process can often conclude with “let’s wait for a better price.”

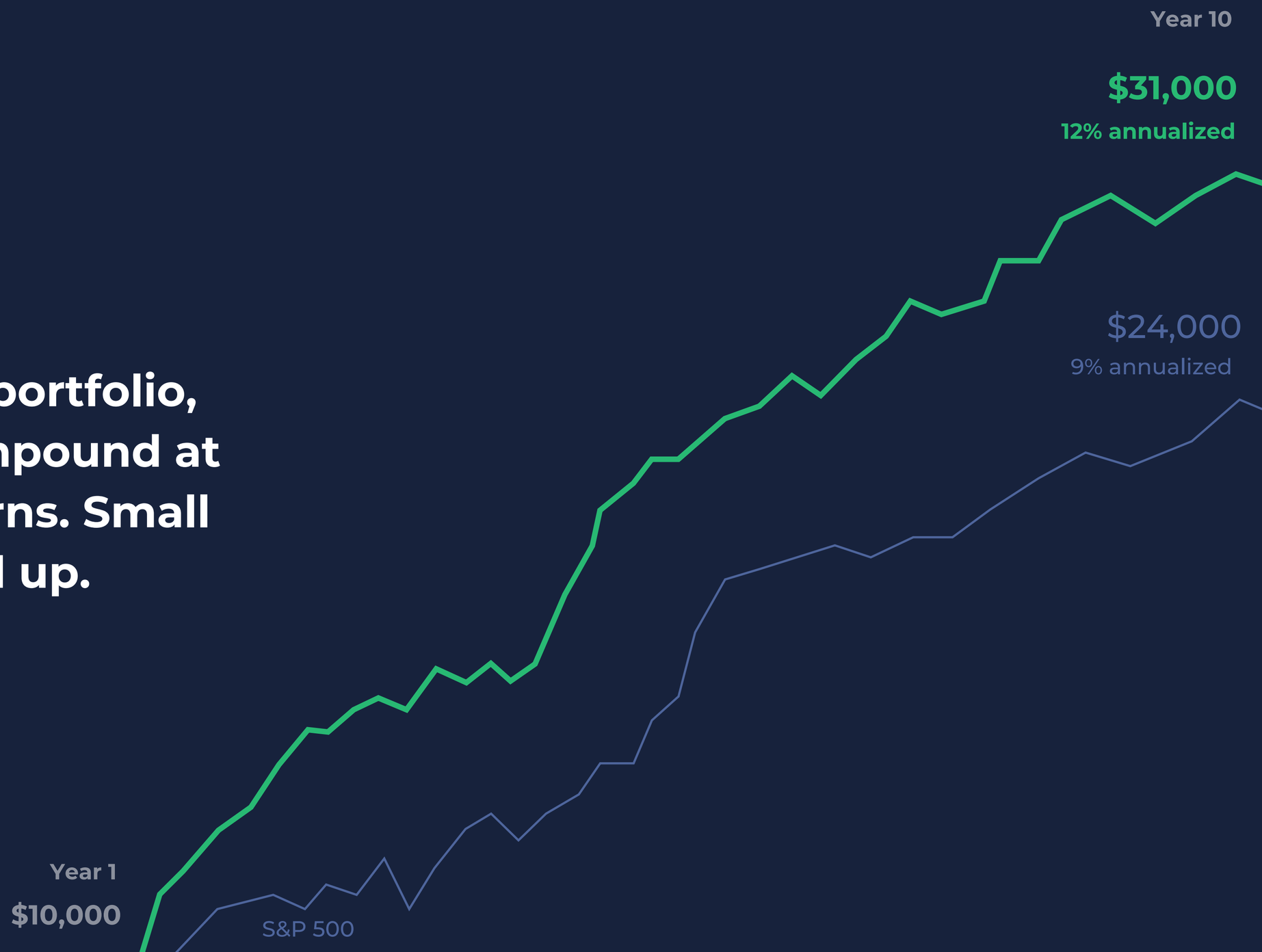
THE PROCESS

Once you've found one quality investment, you need do this 20 more times to create a portfolio.

THE PROCESS

With the right portfolio, capital can compound at incredible returns. Small differences add up.

"Compound interest is the 8th wonder of the world." **Einstein**



THE PROCESS

But this isn’t easy. Being a great investor requires skills that only experience can teach.

Courage to be contrarian

Often the best investments are when you can confidently go against the wind.

Balancing patience with action

One can wait forever for the perfect pitch, but ultimately no investment is perfect.

Expertise to weigh mixed data

Sometimes you have to know how to assess trade-offs versus establish non-negotiables.

TITAN

At Titan, we manage the capital of thousands of investors with a similar philosophy in mind.

LEARN MORE

TITAN

About the authors.

Clay, Joe, Max

Clay Gardner has been investing since age 12. He spent his career as an investor at multi-billion dollar hedge funds, applying a long-term, quality-oriented approach. He also spent time in private equity. He graduated from the Wharton School and the School of Engineering at the University of Pennsylvania, with degrees in Economics and Computer Science.

Joe Percoco has deep operational expertise. He spent time at McKinsey & Co. in their technology practice, at Goldman Sachs in NYC, and most recently at a long/short equity hedge fund. He graduated from the Wharton School and the School of Arts & Sciences at the University of Pennsylvania, with degrees in Economics and International Studies.

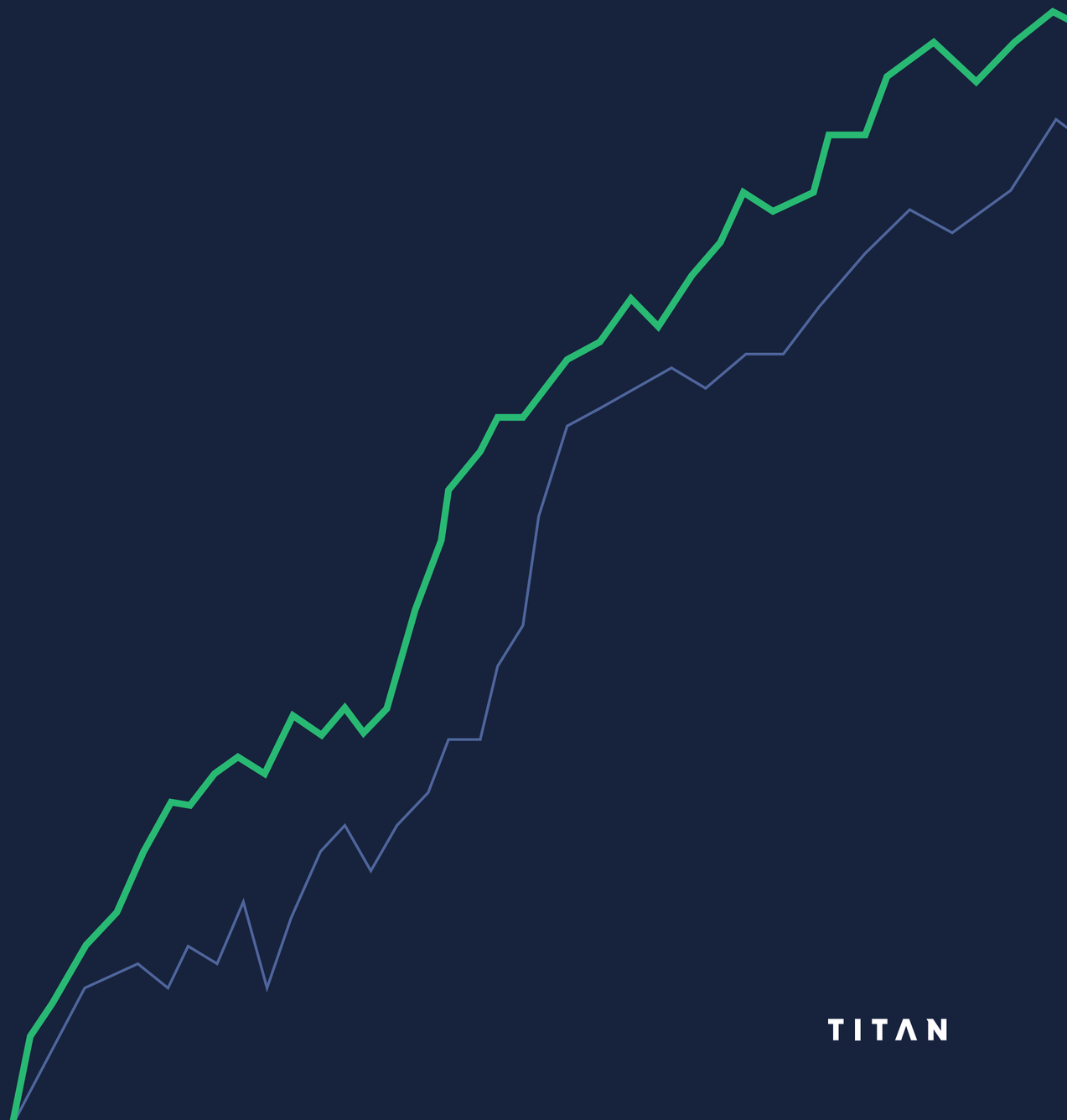
Max has a patent in hedge fund software. In addition to his time at a hedge fund, he was a senior engineer and early employee at several early-stage technology companies, including Relay Delivery and AppNexus, leading teams of engineers and deploying systems to thousands of stakeholders. He graduated from Stanford University with a degree in Computer Science.

Thank you.

“If you want to build a ship, don't drum up people to collect wood and don't assign them tasks and work, but rather teach them to long for the endless immensity of the sea.”

ANTOINE DE SAINT-EXUPERY

Cited in Netflix’s culture presentation



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