

Our Investment Framework

In 2001, we published an article that outlined our investment framework and how it worked. Since then, the world in general and financial markets in particular have evolved massively.

Stock market participation has soared, as retail investors have increasingly decided to “play the market” (a trend that only accelerated during the COVID-19 pandemic). Corporate information is more broadly and quickly disseminated, and technology – in particular, algorithmic trading – has enabled market participants to respond in real time, which in turn has made exploiting anomalies more challenging. Momentum-based strategies have come to the fore, and the popularity of ETFs has radically altered market dynamics. Meanwhile, the macroeconomic landscape has shifted. We have witnessed two global recessions of unprecedented scale and two corresponding periods of unprecedented government spending, while central bank policy has engendered an environment of historically low yields and historically high levels of debt.

We could, of course, go on, but let us not belabor the obvious: times have changed for investors, as they have for everybody.

Given that reality, we decided to revisit and, where appropriate, refresh our investment framework, which we dubbed “CISSEMT” back in 2001. As we did so, we formally recognized two things that were already quite clear to us (and our clients) informally. One is that the CISSEMT investment framework has served KJH Investors (and our clients) quite well so far in the 21st century, even as the global economy, the markets, and the firm itself have evolved. The other is that CISSEMT remains a robust, effective, and practical framework – one that we continue to follow and to which we are still committed, even if the acronym falls no more trippingly off the tongue than it did two decades ago.

It is important to understand the CISSEMT framework within the context of KJH’s overall approach to managing our clients’ wealth. Our rule is that while you cannot predict what will happen in the markets (or the world), you can prepare. So, when we invest, we begin with an asset allocation model – first and foremost. We believe that allocating clients’ assets across a spectrum of equity and credit strategies can deliver risk mitigation against market downturns, while also putting their portfolios in a strong position to capitalize on upside opportunities. To achieve those allocations, we use carefully constructed equity and credit strategies, and we work with clients to develop the right mix to help mitigate

losses in down markets and do well in bull markets. That is our No. 1 job.

Expressing these strategies is where our investment framework comes in, as it informs the way we identify and select the securities within the funds. “Informs” suggests an important distinction: the CISSEMT framework is not a manifesto, or a diktat, or a religion, but rather a set of criteria and tactical guardrails that our investment team employs to find appropriate opportunities and mitigate risk. To be honest, very few of the securities in the portfolios –very few securities anywhere – meet all the criteria of the CISSEMT framework. But diversity and flexibility are among its greatest benefits.

CISSEMT takes into account several factors, and it has allowed us to adapt to ever-changing business models and capture opportunities that rigidly applied traditional metrics might well miss. It also allows us to incorporate macroeconomic views when considering a security, as well as the way market dynamics (or the lack of them) might impact returns in particular sectors or industries.

There is much more that we like about our framework. It emphasizes bottom-up analysis and due diligence, which have been among KJH’s strengths since our founding. It deters us not only from chasing the market’s next bright shiny

object, but also from falling in love with a “cheap” security and pounding the table for years waiting for the rest of the world to appreciate the stock’s true value.

We are stubborn in our commitment to preserving and enhancing our clients’ wealth, but more ecumenical in the securities with which we fulfill that commitment. The fact that we still evaluate opportunities in the same way we did 20 years ago speaks to the strength of the CISSEMT framework – and to the way KJH has evolved as markets have evolved.

This might seem a long way to simply say “not much has changed,” and those who were already familiar with the CISSEMT framework will find few surprises in the updated explanatory note below. Yet we thought it important, nevertheless, to reaffirm our commitment to our investment model, as well as ensure that our description of it is as clear and relevant to our clients as the model itself.

C: CATALYST

We like to buy companies that trade at a discount to our estimate of the private market value of the company. If we can buy a one-dollar stock for 50 cents, then we have a margin of safety, and we can wait for the market to recognize its errors in creating the anomaly. We have, however, long recognized the potential weaknesses in this approach, which can

be grouped under the broad categories of time and liquidity. First, company valuations in the public markets can remain well below our (hypothetical) private market valuations for many years, exceeding our clients' time frames as well as eroding the rate of return that we ultimately earn. Second, some "underpriced" stocks do not trade at their perceived intrinsic value simply because nobody (or next to nobody) trades them at all. If we were to be purely price-oriented, we could well end up owning too many "orphaned" companies that are of little relevance to investors.

What might be among the factors that could push a security out of the price doldrums? One is the "C" in our CISSEMT framework: a potential catalyst that will accelerate our rate of return. In some cases, the catalyst is relatively easy to identify, but that only increases the chances that the market has already priced it in. In other situations, catalysts need to be found. For example, governance in some companies is extremely poor, and activist activities can serve as a catalyst. Other companies might be undertaking management or sales force renewals, or they might be potential targets for acquisition – these, too, can serve as catalysts for the share price.

Logically enough, wider dissemination of corporate information and the alacrity

with which markets respond have made the task of identifying catalysts much more challenging than it was even 20 years ago. For us, however, that reality only emphasizes the wisdom of our bottom-up approach to security analysis, which relies heavily on company-level research and thorough due diligence to identify opportunities that the broader market might have overlooked.

I: IMPORTANT

In our CISSEMT framework, "I" stands for important. It is also one of the most "important" of our investment criteria. In short, we look for companies that have a unique market position or unique assets of some type. That means we tend to focus on industry leaders or companies in oligopolistic environments, as opposed to small, marginal players. One of the questions we always like to ask is, "If this company didn't exist, would anybody miss it?" If the answer is no, it's not very important – and we are unlikely to buy.

Important companies tend to enjoy significant advantages over others, in terms of both revenue and costs. As well, undervalued leaders may be attractive takeover targets for strategic acquirers. And institutional investors tend to focus on such leaders in any market environment, whereas tertiary players are often ignored for longer periods of time in poor markets. By staying in important

companies, we believe we will have higher-quality portfolios, which will attract the liquidity necessary to ensure robust returns.

We particularly like important companies that have a distinct competitive advantage – especially a high barrier to entry from competitors. If there is no competitive moat around a company, other companies can come in and turn a great business into just an average business. An unassailable competitive advantage prevents that from happening.

S: SECULAR

The first “S” in our framework stands for secular, which refers to a multi-year trend versus a short term, or cyclical, trend. Secular trends often arise due to demographic factors or the reversal of long-standing industry trends. The dissemination and impact of digital technology and the aging of populations in western democracies provide two good examples of secular trends.

In our view, value-oriented buyers too often bought businesses that were cheap but had a lousy secular trend underlying them. Some stocks are underpriced on a fundamental basis for good reason: long-term factors threaten future cash flows. (The best management teams in the world could not have saved the VHS tape industry!) In contrast, we want to invest in companies that have great secular

trends, because the underlying demand dynamics will enhance the growth of the company and institutional interest in its services. Positive secular forces go a long way towards defining great business opportunities, so our biggest commitments will be to businesses that have a positive secular tailwind.

Being on the right side of a secular trend also helps us avoid value traps. A bad company with a good secular trend behind it can still perform well, but a “good” investment in a company going against a secular trend can torpedo a portfolio. As well, a long-term trend implies that an investment has the potential to compound returns over time. On the other hand, if one were to simply buy a cheap security and watch its price rise to meet its intrinsic value, that would be the end of the story – and you would have to buy and sell it at just the right time to realize that relatively underwhelming gain.

S: SCORE

We adopted our scoring regime in the 1990s, and it continues to be a useful element in identifying opportunities. In essence, we analyze all companies on a variety of important criteria, such as valuation parameters, growth rates, valuation ranges and more subjective factors such as management and neglect. We then calculate an aggregate

score based on the sum of these elements. This system is not a panacea, of course, but it has kept us out of companies with bad balance sheets, and at other times has forced us to wait for companies to reach historically outstanding price levels. Scoring helps us maintain a disciplined investing approach, and it sets a high bar. But as we often say, we need only 20 or 30 companies out of more than 40,000 (the number of publicly traded companies in the world), and our scoring system helps us to quickly discard or pursue ideas.

E: EXPECTANCY

Expectancy is a rather pretentious expression for risk versus reward, or upside versus downside. We will often consider such relationships on a numerical scale. If expectancy is 10, for instance, we mean that the investment has \$10 of upside against \$1 of downside. We are looking for investments that offer profoundly good risk/reward ratios. Admittedly, boldly saying that a certain stock has “\$2 of downside” overstates the science. Therefore, we look for historical pricing and other factors in determining reasonable estimates of downside risk. If we follow our “S-Score” process, we should be buying at reasonable valuations, which itself limits risk. We like to say that if we are wrong in a security pick, we want to get our money

back. Measuring “expectancy” in this way can help us do that.

M: MANAGEMENT

Assessing management is rarely easy. Over the years, we have encountered terrible companies with great management and great companies with terrible management. Assessing which is which requires a balanced review of financial track record, strategic success, philosophy, character, and passion. There is no substitute for due diligence.

Wherever possible, we like to talk to past employees, competitors and past employers, in an effort to understand the competence and character of the management team. We definitely like to visit companies, which affords us a real sense of the business and the context in which it operates. Likewise, judging past successes is not as easy as simply looking at financial results. A balanced measure of financial performance, organization building and tough strategic choices are required. Of course, this takes time, and it is the reason we often build positions in companies slowly, as we develop more confidence in the people.

Generally, we prefer situations where management has significant “skin in the game”—preferably, a large portion of their net worth tied up in the company. We dislike it when management are

option holders only, and we avoid situations where a company has over-issued options to its executives. Management should think like owners, avoiding empire-building and other behaviours that might act against us as owners. At the end of the day, we want to buy into an honest, owner-oriented management team that is regarded as best in its industry.

T: TECHNICAL

The “T,” or technical, element is often tricky. There are really two aspects to it. One lies in the realm of quantitative analysis, which looks at stock performance in terms of base formation, breakouts, levels of support, and other chartable factors. We certainly pay attention to those when appropriate, but our technical analysis also takes into account the size and quality of the shareholder base supporting a particular security. For example, an equity might be enjoying spectacular price appreciation as a result of “hot” money pouring into it, but we would tend to wait until the momentum investors have departed and larger, long-term focused investors begin to gravitate towards the stock. Their support makes us more confident that the security’s investor base is not going to hit the sell butt on at the first sign of trouble. Then, if the stock “breaks out,” we try to add to our position, and if it hits what we believe to be fair value, we often

try to “scale sell,” taking some money off the table but keeping part of our position as other investors take the share price increasingly higher.

This last piece is particularly difficult for many investors, but for the most part we distrust the market and assiduously avoid holding assets that appear to be getting expensive.