

Our AIM Investment Philosophy

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Stephen joined the company in 2020 and is responsible for analysing, selecting and monitoring stocks for the Stellar AiM IHT Service. He holds the CISI Diploma and the Chartered Financial Analyst (CFA) designation.



Intrinsic Value

In theory, shareholder returns should match the company's cost of equity and intrinsic value broadly tracks the cost of equity every year. An investor's objective therefore is simple. Buy when the share price is below a stock's intrinsic value and sell when it rises above it. That is the theory but as Yogi Berra said, "In theory there is no difference between theory and practice. In practice there is."

More dishearteningly, even if it was possible to know a stock's intrinsic value with absolute certainty, it tells you little about the subsequent share price action. The price may remain adrift from intrinsic value for years before it eventually converges. This represents a potentially high cost, known as Opportunity Cost, and because of its more implicit nature (you lost out on potential upside) against a more explicit cost (you lost money) investors often fail to view the two as being of equal significance.

Intrinsic value is highly important, and investors must have an appreciation of it, but the more

dominant driver of a share price is how other investors perceive the company and its prospects. If a company is perceived to have precarious finances due to high debt levels, despite having ample asset backing such as land and buildings, then it has weak finances. Accept it and, above all, don't let your own prejudices get in the way of making money.

The bull market which started in 2009 is often dubbed the most hated in history. Why? Most sat on the sidelines believing QE policies would be at best, ineffective and at worst, fatal, while others made hay. They may well be proven 'right' eventually but the victory will be a pyrrhic one given the amount of gains that could have been harvested in the meantime. Being too early with a call is imperceptibly different to being wrong. They ignored other investors' perceptions in favour of their own version of reality, believing everyone else to be wrong. As George Soros said, however, "It's not whether you're right or wrong that's important, but how much money you make."

Efficiency

Stock markets are incredibly efficient at assimilating information. You can view the price as the single best 'indicator' available, distilling thousands of investors' fragmentary insights into just one all encompassing metric.

The world is both incredibly complex and uncertain and people are ultimately fallible. Soros takes this one step further when he talks of 'reflexivity' where investors take their cue from the price action which itself comes from others reacting to others. It can often trigger a chain reaction.

Inefficiency

Small-cap stocks represent perhaps one of the last bastions of market inefficiency (where price is not reflective of intrinsic value) given the low analyst coverage and lack of interest from the monolithic fund management groups. Large-caps are generally more efficiently priced which reduces the amount of true pricing anomalies where price seldom deviates from intrinsic value for long and when it does it isn't by much. Small-caps on the other hand throw up much larger pricing anomalies with much greater regularity. This is fertile hunting ground for nimble stock pickers.

We've found that companies with a market capitalisation of below £150m offer particularly good value on a risk adjusted basis and is a space I deliberately target. As a company gets bigger it starts to attract larger fund management groups who were unable or unwilling to buy the stock when it was below some self-imposed market-cap threshold.

As small-caps get bigger and attract buying from the large fund management groups the Price Earnings (PE) ratio often re-rates higher,



say from a low 8 times to a much fuller 20 times (price is equal to 20 times the earnings per share). This is likely at the same time that earnings are also growing providing further share price impetus. This re-rating allows us to effectively arbitrage company size, getting in early when it is smaller, cheaper and shunned and exiting when it becomes larger, dearer and coveted. We can do this by virtue of our own size, which allows us to tread where larger peers cannot. **We will curtail inflows into the IHT strategy if and when we feel it starts to impair our ability to pick the very best value.**

Multi-disciplines

I believe that to unlock hidden value within small-caps it requires an approach spanning three key disciplines:



Quantitative (30%)



Qualitative (30%)



Psychological (40%)

Quantitative is numerical in nature covering economics, accounting, mathematics, probability, valuations etc. One must have adequate competency in this and be comfortable navigating through accounts, where the balance sheet, cash-flow statement and income statement should all tell the same story.

Qualitative deals with the more intangible aspects of investment such as weighing up the competence and integrity of management, gauging competitive threats, assessing pricing power, the composition of the board, quality and extent of research & development, the incentives of management and the sustainability of profits. Qualitative factors will give positive and negative answers; it's up to the investor to properly weight each factor to arrive at an overall conclusion.

You can see then that **Psychological** at 40% is the factor I consider to be the single most important and is the one that I will spend a disproportionate amount of time exploring.

Read, a lot

To enhance the above skill set it is imperative to read as much and as widely as possible, no matter how seemingly tangential. The aim is to be more 'T' with the horizontal part of the letter representing breadth of knowledge and the vertical depth of knowledge.

Reading a lot also helps to identify emerging trends, threats, opportunities and builds up a rich tapestry of wisdom from which you can draw when assessing company prospects. This is not only invaluable in identifying tomorrow's winners but equally helpful in identifying tomorrow's losers. I take as much pride in sidestepping investments that sour as I do when they blossom. Avoiding a 33% loss is identical in every respect to making a 33% gain. **Some of the best investments are the ones you don't make.** Warren Buffett has three investment trays: Yes; No; and Too Hard.

Driving using the rear view mirror

Investing should be boring, with the most money made just by sitting rather than trading. This drudgery can be too much like hard work for some investors, especially if others are making money when they aren't. Envy leads investors to chase top-performing stocks often buying in the latter stages of a bull market. The renowned investor Howard Marks, founder of Oaktree Capital, got it spot on when he observed **"There's only one way to describe most investors: trend followers."** This applies equally well to both amateur and professional investors alike. Next time you simply must buy something, stop, take a step back and ask yourself why. Is it because, on a forward looking basis, you feel the price undervalues future prospects? Or is it because the price has risen appreciably and everyone is waxing lyrical about it? Invert their enthusiasm and ask if everyone is so bullish then a lot/most of the buying has already taken place. **The higher the price you pay the less return you are accepting.** By reframing it in these terms you are straight away ahead of most private (and professional) investors.

Unforced errors

Another major common error is a lack of process which leads to unforced errors.

Much of this Philosophy is in essence the process I follow. Process though is only half of the equation, the other is execution. Execution is the actual pulling of the trigger and physically buying or selling when the process dictates that you do so. While the process is dispassionate, people aren't, and they often fail to execute when they should. **Without execution process is impotent.** A pilot has a checklist to physically force him or her to follow a predetermined sequence of actions to avert disaster during an emergency and investors should have their own version too.

Execution also encapsulates the portfolio and the rules that govern its construction. It's having a maximum limit of 40 stocks so capital is always competing for the best ideas and ensuring that risk has been spread properly.

Execution is also about sizing the investment according to your conviction and the liquidity of the company's shares. We have a minimum initial investment limit of 1.5% up to a maximum of 5%.





Thinking two-shots ahead

It can be said that today's contrarian is tomorrow's conventionalist, where thoughts deemed ridiculous at the time come to be viewed as prescient and eventually accepted as common knowledge. As ever the share price keeps score on this evolving narrative. Is there a pathway then to reach such conventionalism? Thankfully there is, you just need to re-map the way your brain thinks.

Ronnie O'Sullivan, probably the best talent ever to play the game of snooker, thinks 'two shots ahead' when playing so he can best plan what order to pot the balls in to build the highest scoring break. Investors too should adopt this approach to portfolio building, to be positioned the right side of a stock (to hold or not to hold). People often think a 'good' company makes for a 'good' investment but if enough think that then the share price is high and future returns will be low.

Identifying whether a company is a 'good' or 'bad' one today isn't terribly profitable, the trick is identifying a path where the 'good' turn 'bad' and the 'bad' turn 'good'

I am mainly interested in what a stock looks like in two years' time than I am in its current state because:

- ★ The current is priced in and much beyond a year isn't, and
- ★ You can get in or out of a stock in good time, and a better price, as opposed to peers who seek to exit just before midnight but 'are dancing in a room in which the clocks have no hands' (Buffett).

Increase Robustness

Unfortunately investors crave certainty and one means of achieving this is by reconstituting history ex post so that it was entirely predictable. The outcome of history, however, massively understates the variability of potential outcomes. It is crucial therefore to make your portfolio as robust as possible to cope with a range of outcomes rather than just one or two that you feel certain will transpire. **Knowing what you don't know lets you get on with what you do.** It's hard enough trying to predict next quarter's results let alone multi-years out where forecasters tend to just extrapolate the recent past in a linear fashion. Events alas rarely follow such a straight line.

I strive to increase robustness by constantly recycling the expensive holdings back into cheap holdings. Forest managers learnt long ago that it is better to let a forest adjust by letting a series of small fires rage, in this way you avoid an inferno and huge loss.

I like to also have a good number on PEs of around 10 times or less. **Risk is primarily a function of price.** The higher the price, or valuation, the higher the downside risk. Moreover, as a stock's valuation rises its riskiness increases at an increasing rate. In other words the higher the expectation the greater the chance of disappointment - parents and children will both no doubt relate to this.

I also look to diversify by investment style, across Value and Growth, where the former tends to outperform the latter over the long-term. There are periods, however, where Growth's outperformance can last for several years. It is nigh on impossible to predict when one style will lose out to the other and when to switch styles. As such I prefer to maintain an ongoing balance in the portfolio between Value and Growth at a Reasonable Price (GARP). In this way we are hedging our bets which across the cycle should improve risk adjusted returns. GARP is quite different to out and out Growth investing, where the latter is concerned with identifying super normal earnings growth rate. GARP investing is associated with much more mature companies which are profitable today and offer good growth relative to the price paid.

Win by not losing

We believe that true investment risk is permanent loss of capital, rather than volatility which is more a symptom of risk and more closely linked to liquidity. The more volatile the stock the less liquid it is (it may be at a depressed level so you hold off until it recovers). When flying I'm more bothered about the risk of crashing than the amount of turbulence. Paradoxically, we try to grow investment values by not focussing on stocks that will shoot the lights out (they invariably don't) but the inverse, concentrating on risk management and those stocks that will survive across the cycle. It's a subtle but key difference, akin to fighting a rear-guard action. Get your risk controls right and the upside will look after itself. This is about finding companies with growing demand for their product, a robust business model, long-term focussed management teams with sizable 'skin in the game' in terms of equity ownership, and which are reasonably priced.

Time the market but not with cash

The nature of the IHT strategy means we must be fully invested at all times and this actually improves returns. To explain, some investors try to time the market by going into cash. This means you have to call the very top of the market with precision, getting bearish before the bulls do, and also spot the market before it bottoms to the day and get the money reinvested. This is impossible to do and statistics show just how damaging it can be to returns if you miss out on just the best five days of performance, a doubling of profit could and should have been a tripling of profit but due to missing the five best days gains were left of the table. Over a ten year period you could be 99.8% accurate in terms of choosing which days to be in and out of the market and still kill your returns.



The whole matters

When I talk of the portfolio I mean just that, the whole rather than a focus on the constituent parts. What matters only is the bottom-line portfolio valuation and over time hopefully nudging that value upwards. One of our jobs is to make that experience as palatable as possible but we are not at value upwards. One of our jobs is to make that experience as palatable as possible but we are not designing a low volatility outcome. It's the consequence of volatility, rather than volatility itself, that has the most impact on investors. If you need to withdraw capital at short notice than volatility absolutely is of paramount concern. Yet, investing in equities should only be considered by those with a medium to long-term horizon. The longer you stay invested the less risky equities become. **Time transforms risk.** Too many investors now want the return without the risk but the balance between the two is one we need to get right. This is where the Philosophy steps in.

Sell discipline

Investing is practicing the art of the relative. Limiting the number of stocks to a maximum encourages a constant and healthy competition for capital; if the risk/reward deteriorates enough relative to another stock then it should be replaced. **Your buys are distinguished by how well you sell.** Over time by thinking relatively i.e. what do you think are the 25-40 best stocks relative to the whole investable universe, your portfolio should deliver very attractive risk adjusted returns. In other words, strong absolute performance is a by-product of skilled identification of the best relative ideas. It's a subtle but hugely significant point to note, and makes investing much more straightforward than trying to find stocks you believe will go up say 20%. This requires selling stocks if and when a better one comes along and/or you have higher conviction on it. Investors often fail to sell due to regret aversion, avoiding regret if they sell and the price goes up. Reframe a sell decision away from trying to pick the share price apogee 'to my conviction is now only 50% but is 90% on another stock'. Repeat this often enough and it will pay handsomely over the long-term (assuming your conviction levels are reasonably accurate).

Charting returns

Charts are very useful indicators of broad trends but too much focus on them can put you off investing (if they have risen a lot) or dissuade you from selling (if fallen a lot). Some of my best trades have come from buying stocks that have risen a lot in value already, the trick is to be entirely forward focussed in terms of future prospects over the next 2-3 years. I've often glimpsed at charts and thought 'I've missed the boat' but took a meeting with management anyway and walked away a buyer of the stock given the outlook was so strong. These generally work out well.

Investing well is full of paradoxes, some of which I've outlined, and Philosophy runs deep in stock markets. They are as beguiling as they are bewildering, their present state "the effect of its past and the cause of its future." (Laplace). This Philosophy is designed to foster flexibility of thought, creativity and freedom to execute ideas. Like a parachute the mind works best when open. That said, if left unchecked those admirable and required traits can wreak untold havoc on a portfolio's bottom line. Portfolio construction is an absolutely vital component in the investment process, it is as fundamental as a skeleton is to a person. Remember, Process and Execution.

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Moreover, wherever there is the potential for profit there is also the possibility for loss, particularly in smaller capitalised companies which tend to be higher risk and possess lower liquidity than larger stocks.