COBURN VENTURES

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CIO DIARY: FOUR JOBS OF STOCK PICKING: FRAMING ANALYST-PORTFOLIO MANAGER SYNERGY

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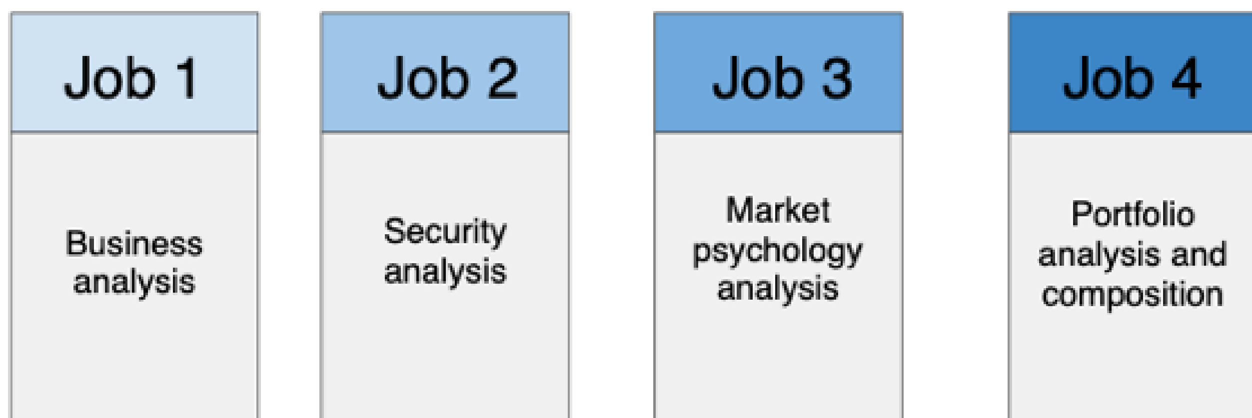
JANUARY 8, 2020

"From listening comes knowledge. From knowledge comes understanding. From understanding comes wisdom. From wisdom comes well-being"

—a Maori proverb



What I offer below is not meant as a "division of labor" so much as a framework for effective synergy.

I was going to lead in with a story of a time I went to analyst day in Ottawa at Newbridge Networks many moons ago that might be a great lead-in for this piece.

In fact, I wrote a draft. Then I deleted it.

But here is an encapsulated version. One takeaway is, it was all my fault. I will get back to that at the end of this note.

The situation: A portfolio manager – Brad – asked me what I thought of taking a position in Newbridge Networks for which I was the analyst.

I was super clear: DON'T buy it.

I diligently went to the analyst day.

While I was there, he took a position without talking with me or explaining why.

I saved us a page or two of the details.

I suspect this encapsulated version is enough.

We have all been "there."

But why am I raising this at any rate?

I think the job of "stock picking" has four distinct components.

When we consider it is just one activity, it turns the potentially lucrative complementary-ness of the activity where the best of analysts and portfolio managers shines together into at times a nightmare.

Analysts feel all sorts of negative things, including not being trusted or valued, feeling envious at not being the trigger-puller, or being told they need to communicate better or "sell" their ideas. A lot of hierarchical gunk gets triggered. And sometimes the PM isn't even asking relevant questions and asks ceaseless irrelevant questions that require the analyst to do gobs of extra (senseless) work.

And portfolio managers sometimes feel pressed/annoyed as well by having to explain their thinking process when the analyst "knows" more. They are called upon to defend their opposite action or they might succumb to "taking just a small position" and dodging an analyst who is coming around again to "sell" the idea even better when they have zero intent to ever buy it.

There become issues of "ownership" and "representation" and "horse-trading."

Second-guessing our colleagues' actions selectively.

Potential for varying levels of toxicity.

I could expand for pages.

I won't.

I suspect we have all been there at one point or another.

There is high potential for a normalized sub-optimal investment process. There is a high potential for even a terrible investment process.

There will be plenty of convivial dysfunction.

There might be a great deal of camouflaged animosity.

I think in breaking down this single job – stock picking – into four components we can potentially

dramatically alter communication and turn the angst and friction into a powerful complementary-ness.

When I hear the words "stock picking," I instantly consider four distinct, MAJOR jobs to accomplish.

There are many ways for a group of analysts and portfolio managers to pursue these four tasks with the greatest of teamwork.

BUT...

When we instead aim to reduce the four jobs of "stock picking" into one...trouble often ensues.

I contend that when analysts and portfolio managers work as a great team, it is when they see their distinct roles and ability in these four jobs and feel that each aspect is vital. If celebrated/rewarded for doing their specific parts exquisitely, and if the communication is enhanced by recognizing these four tasks, a lot of great outcomes will result.

But what are the four distinct, MAJOR jobs?

#1 **Business Analysis:** Purpose ⟶ Forecasting future cash flows of a company.

#2 **Security Analysis:** Purpose ⟶ Assessing what the stock market is asking us to pay for the privilege to own shares in that company.

#3 **Market Psychology Analysis:** Purpose ⟶ Overlaying the collective "market's" psychological orientation toward "valuing" the shares of a company.

#4 **Portfolio Analysis + Composition:** Purpose ⟶ Contextualizing this specific investment opportunity with regard to all factors involving a portfolio.

Analysts and portfolio managers have different jobs in the four distinct MAJOR jobs I mentioned above.

And...an investment team is expected to have differing degrees of competency in these four activities.
What do I mean?

Imagine if an outside consultant asked a simple question:

"Would you rate your skill from 1-10 at the four distinct jobs in stock picking?"

The "right answer" from longer-term fundamental investment firms might look like:

#1 **Business Analysis** ⟶ 9

#2 **Security Analysis** ⟶ 6

#3 **Market Psychology** ⟶ 5

#4 **Portfolio Analysis and Composition** ⟶ 5

Any answer deviating far from the above, which would imply that these four jobs were "equally" important, and your group was equally competent, would be a turnoff. But it is also possible to add relative, incremental value above peers in each of the jobs.

So far, I am suggesting that...

POINT 1: "Stock picking" is four jobs: not one.

POINT 2: When teams act like there is just one job, there are often systematic problems.

POINT 3: Analysts and Portfolio Managers have different roles and skills in each of the four jobs.

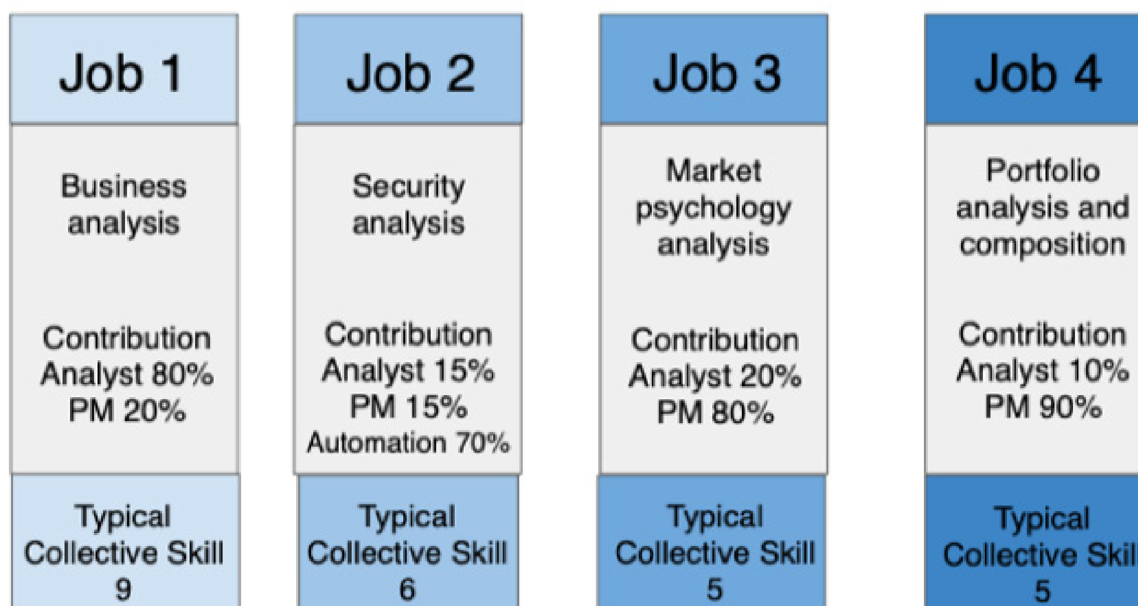
POINT 4: The jobs have different potential levels of competence for a team.

POINT 5: There is potential to add value in all four jobs.

THE FOUR JOBS

I am going to work through the four jobs.

Here we go...



#1 BUSINESS ANALYSIS

Job #1, business analysis, might be some theoretical 80% analyst contribution and 20% portfolio manager contribution.

Without doing Job #1 right, very little else will work for very long.

Both can play meaningful roles!!!

Analyst Contribution:

- Gathering relevant knowledge
- Avoiding trivial/irrelevant knowledge
- Being able to distinguish one from the other with expertise and expediency
- Context generation
- Converting knowledge into insight ("Insight" defined here as: an uncommon understanding of a particular matter that might significantly enhance the ability to forecast future business cash flows.)

Analyst Trap:

- Pursuing knowledge past the point of positive substantive return
- Too much knowledge-building that wastes time and makes seeing the signal and developing insight (Making the haystack foolishly bigger so it becomes harder and harder to find the needle.)

Portfolio Manager Contribution:

- Asking unlocking questions
- Using powerful heuristics and pattern recognition
- Adding relevant, indirectly related analogy
- Injecting analytical firepower surgically from prior experience as an analyst
- Observational distance!

Portfolio Manager Trap:

- Duplicating the analyst efforts (often occurs with a newly-minted PM)
- Using patterns and heuristics sloppily
- Not incorporating analysts' portion thoroughly

The general goal in business analysis: to generate insights (uncommon understandings of a business that lead to abnormally high conviction in future financial cash flows).

Both the analyst and the portfolio manager have vital roles in this job. Portfolio managers tend to have exceptional analytical backgrounds. They have analytical skills to add to the core analyst capacity. The synergy here is almost a must. **Often an analyst will want to have THE SAY on the business analysis and wish to do the job on their own. What a mistake here in 2021 when collaboration has been all the rage for a decade.** Sometimes an analyst is subconsciously considering "credit" or that ugly, ugly industry word "attribution" and actively resists the surgical inputs from a talented portfolio manager. If you want systematic convivial dysfunction and camouflaged animosity, develop a robust attribution analysis. If you want analyst/portfolio manager synergy, consider weakening attribution or blowing it up completely.

Warning to analysts either way: "Go it alone" at your own peril.

At the same time, portfolio managers often regress or devolve into inquisitors instead of partners. This can be drastically exacerbated that there is often an embedded hierarchy in our industry: portfolio managers are more powerful and more senior than analysts. The career track is to become a trigger-pulling portfolio manager. IF you can weaken or blow up hierarchy, even just in the moment of partnering on Job #1 business analysis, THAT would be very, very helpful. In the normal world, however, we do observe and, sadly, expect to see portfolio managers conducting an inquisition. Instead of partnership and synergy and all that good stuff we arrive at contention, defending, "expert," "and Superhero Falsification."

...convivial dysfunction...

...camouflaged animosity...

#2 SECURITY ANALYSIS

Job #2 might be 15% portfolio manager contribution and 15% analyst contribution and 70% automation.

Security analysis might also be called "valuation analysis."

And it is the least "job" of all four jobs.

"Security Analysis" is a fancy way of asking, **"how much am I being asked to pay for the privilege of owning a specific call on part of the entity's future cash flows?"**

In some valuation work in other industries (e.g. homeownership, apparel, food, concert tickets, Disney World), it isn't very clear WHAT someone is comparing the price to. Is the value of a concert ticket per song? Is food really just by "ounces"? Homeownership by square footage or number of teachers in the school district? Do we calculate price unit per "great memory created" at Disney World? In most industries, pricing/valuation can be quite ephemeral. Not so much in equity security analysis. We have different forms of contemplating future cash flows and discounting them back but – in theory – we all agree that the value of

an enterprise hinges on the discounted future cash flows. As one friend long ago said: "Valuation is a real and defined thing…it is just impossible to actually calculate. When people say 'valuation,' usually they mean market price and we want to compare that to the theoretical true valuation – discounted future cash flows – and then see if something is cheap or expensive."

Presumably, we are looking to understand the basic ratio of cost per some "fundamental financial metric" as a short cut in understanding the market price we are being asked to pay in terms we can relate to true inherent "value."

Neither an analyst nor portfolio manager would be wise in spending too much time on this activity. The automation of a gazillion ratios is best outsourced to Bloomberg. The market has often clearly stated which specific metrics it will employ. So, analysts and portfolio managers can outsource that as well.

Any really good argument – and distinctiveness – about security analysis is almost certainly going to bleed back into business analysis itself.

Why?

Well, because we have all these ratios. The numerator is the price of the shares and THAT is known. It is the denominator that is an estimate and most certainly wrong in some way and to some extent. Great "security analysis" will be about playing with the fundamental sensitivity so as to see what is wrong.

Analysts might tend to generate their own estimates which is all well and good to plug into security analysis with zero extra effort. Understanding sensitivity can be helpful. Which company is likely to become a so-called "compounder" in vastly outstripping the terminal growth rate standardized in every DCF and thus embedded in the backend to every PE ratio? That is a business analysis question and an answer was developed in Job #1. Which company will avoid being a so-called "value trap" and as such the future earnings are far more apt to remain steady as opposed to collapsing? That is a business analysis question and an answer was developed in Job #1.

The upshot:

Job #2 Security Analysis is easily automated, doesn't require much time, unto itself is unlikely to be a source of "expertise," and most all of the best work is linked to Job #1 Business Analysis. When done superbly, was an impressive collaboration between analysts and portfolio managers to begin with!

#3 MARKET PSYCHOLOGY ANALYSIS

Job #3 might be 80% portfolio manager contribution and 20% analyst contribution.

If "Security Analysis" is about comparing a bunch of ratios to a theoretical, inherent "valuation" and we might do great "security analysis" really by injecting superb business analysis to spot "compounders" or "value traps," then market psychology analysis is creating determinations of why and to what degree will the wide investment community pay more or less for the privilege of ownership assuming all the fundamental financial metrics about the future are right. In other words, if we assume the denominator is accurate then when the ratios change because people are willing to pay more or less, what is the reason they collectively change their mind?

That is market psychology. It is a plug.

It would be far better to truly hire a psychologist or anthropologist to pursue this craft, not a financial analyst with a CFA and a Wharton MBA. So, the traditional business analyst has a miserable background to perform this function. So do most portfolio managers. It is hard and most participants are not reasonably trained.

But the portfolio manager is apt to be systematically far better to take a crack at it. If analysts might typically rate as a "2" or "3" on a scale of 1-10 in this capacity, perhaps a typical portfolio manager is a "5." Why? Well, many have at least had to ponder the question of market psychology every day and see moves in psychology among various clusters of stocks AND they know that it really really affects returns on an annualized basis far more than business analysis, even if

they don't do it well.

How often in presenting a recommendation might an analyst provide a portfolio manager with even a summary of ratios for competing investments in other sub-sectors? Next to never?? But a portfolio manager is constantly considering – perhaps without too much systematized method – the competition for a portfolio slot among businesses and stocks across a wide variety of industries! They are at least trying!

Portfolio managers also benefit from systematic observational distance that crushes analysts. Analysts are human and the "being too close" can create problems!

Teamwork through this balance of roles and contributions can easily overcome that humanness.

Similarly, in Job #1 "Business Analysis" a great analyst can save a portfolio manager from faulty delusional thinking from not digging in. The analyst digs in to procure relevant knowledge which isn't always "available" knowledge. "Available knowledge" often disorient a portfolio manager. Analysts provide a counter-acting balance.

Teamwork.

How often do you see analysts suggest that the PE ratios in their group ought to go down? Not a lot. Analysts are often biased because of the lack of observational distance.

It is great to have a partnership where one person is way too close balanced by another who has observational distance and I offer one potential hint: portfolio managers don't care as much as analysts about individual stocks!!!! They are paid NOT to! Portfolio managers are paid – as perhaps the title suggests – to create a portfolio. Portfolio managers are not meant to obsess about individual companies and stocks. Analysts are.

What a great recipe for partnership. Uncorrelated inputs.

Job #3 is amazingly important. But it is very hard. Few perform it well. Few have adequate training in actual psychology. The potential to distinguish a group's efforts is enormous. But it can be powerful when it is present. Analysts are extremely poorly trained and positioned to do this Job #3. Portfolio managers may also struggle with market psychology but are far better positioned. We really want to lean heavily on the PMs.

#4 PORTFOLIO COMPOSITION AND ANALYSIS

Job #4 might be 90% portfolio manager contribution and 10% analyst contribution.

The analyst rarely gets involved in seeing the portfolio as a whole, the intention of the portfolio, and typically lacks rich context for the business analysis of all the other choices. The job of the portfolio manager is, precisely, to contextualize the whole of all options.

AN ALTERNATIVE UNIVERSE: BRAD, ME, AND NEWBRIDGE

There may be a lot of habits that undermine the synergy.

Back to the beginning where Brad (portfolio manager) not only didn't follow my advice (analyst) but put the trades in while I was out of town.

Did he really think I wouldn't notice??

This was a communication issue first and foremost.

Let's push a magic button and enter a parallel universe.

Let's suppose Brad and I understood deeply the four jobs and understood our roles and acted as exceptional partners that contributed uncorrelated aspects to stock picking.

In that world, my ego would not have been so impacted at all because I wouldn't have considered that my "worth"

had dropped when I learned through our trader that Brad bought Newbridge shares "against" my recommendation.

I would have known what my contribution was meant to be and what Brad's contribution was meant to be.

Following my business analysis, I might have collaborated on enhancing the business analysis, not "owning" it.

We would have checked out valuation but largely automated it and considered together how that automation was wrong perhaps – that is, taking a step back to Job #1 of business analysis together.

Brad would have added HUGE dollops of his spider sense for market psychology, which he was amazing at...he was truly exceptional at market psychology. At the beginning of the 4Q of 1994, when tech as a percent of the S&P was just 6%, he went to a 30% weighting thinking that tech was going to have a 5-6 year run. This was before the Internet breakout. It was obviously NOT obvious. His spider sense was exceptional on psychology while mine was infantile at best.

And Brad would have layered a lens of portfolio composition and analysis as I had almost zero sense there.

The conversation might have been from Brad:

"Pip, would you do a deep dive analysis on Newbridge and craft a business analysis pre-determined game plan, as well as assembling security analysis ratios for us so we can collaborate on Friday together? I strongly sense that the time for "tier two" somewhat lower-quality companies to run on the market and for a consolidation and merger mania to take place is very high. So, lay out what you see. If it is a terrible company, I don't think a run will be sustainable but if it is 'solid,' I think it might run and there will be a great outcome one way or another, especially if they have enough intellectual property as one of the industry pioneers and research houses. Those are some of my biases at this stage. If we can be in position by Friday to make sure we have a crisp sense of what is relevant at the business core, I think we will be able to generate high conviction together including how this would map into the portfolio."

By the way, I am not blaming Brad that HE SHOULD HAVE said this! He likely recognized my ego and sensitivity and thought sneaking trades in while I was away was his best non-confronting pathway.

I am pretty sure in this situation I was the problem.

I can't recall what happened to Newbridge's stock which – as you might guess – probably means it went up and "Brad was right". High conviction in that without even going back to the charts because if "I had been right" I bet I would recall it down to the percentages!

Hah.

This is a framing and a potential start for comprehending the path toward synergy including the potential for exceptional difference-making communication.

For now...it's a beginning...there is no "I" in team.

Cheers,

PIP

"The greatest problem with communications is the illusion that it has been accomplished"

—GEORGE BERNARD SHAW

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