The Four Keys to Investing in a Stock

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For the past twenty years we have been learning the science of picking stocks to buy. Our methodology has improved dramatically since the early days of our firm and it continues to improve each year.
Like every investor, when we first started in this industry we searched and searched for the one “system” that would produce the results we were looking for. The easier this system the better for us. If we could find an easy to make money for our clients . . . great!
In our attempt to find a system we soon learned that there was nothing simple about finding the ultimate system. In fact, we soon found out that the work that needed to be done to analyze a stock was long and exhausting . . . but well worth it.
Here are the four keys that we believe every stock investment should have. We did not invent these four things. They are core principles that investors, including Warren Buffett, have been following for decades.

1. Invest in sectors and industries that we understand.
2. Find companies that have long term competitive advantages.
3. Look for companies with excellent management.
4. Buy when the stock is available at a good price, discounted to intrinsic value.

Let’s break these down one by one so you understand the methodology.

Principle 1: Invest in sectors and industries that we understand

It would be naïve and flat out risky for us to pretend that we know everything about every sector and industry. That’s impossible. You’ve heard the phrase, “jack of all trades, master of none,” well that’s what happens when you think you can be an expert in every sector and industry. Being the “jack of all trades” doesn’t work in the world of investing. In fact more often than not it ends up as a losing proposition.
Becoming experts in certain areas of the market is the foundation for the next three steps in our process. Without the first step it wouldn’t matter how proficient we are in the next three.

Principle 2: Find companies that have long term competitive advantages.

Imagine in your mind a castle in the middle-ages. Surrounding this castle is a big wide moat with the only access across being a draw bridge. Now think about that moat for a minute . . . why in the world would they build a moat around a castle? The answer is simple, protection.

Warren Buffett refers to “long term competitive advantage” being an “economic moat” for a company. These are companies that have one or more of the following . . .

- A recognizable brand.
- The ability to produce products cheaper than anyone else.
- The ability to sale their product cheaper than anyone else.
- The opportunity to grow at a cheaper cost than anyone else.
- Barriers to entry that make it difficult for competitors or new companies to compete.
- Networking effect where the users of the product or service make the business more valuable. (Think Google or EBay)
- A duopoly situation where two companies dominate the industry (think Boeing and Airbus).

These are just a few of the advantages that we look for and that a few that make up the “economic moat” that Warren Buffett discusses.

Principle 3: Look for companies with excellent management.

The principle of looking for companies with excellent management is not an easy thing to do. We listen to hours of conference calls, read annual and quarterly reports, and study the history of a company’s current management all in an attempt to understand what management is currently doing and what they may do in the future. A few of the things we look for include . . .

- Management’s history of decision making. Do they have the track record of someone that we would actually hire if given a choice?
- Ensuring that management is shareholder friendly. Do they do things that have the best interest of shareholders in mind?
- Understanding how management is compensated. Is their compensation based upon the success of the firm?

These questions and more allow us to answer the question as to whether or not we trust management enough to purchase the stock.

Principle 4: Buy when the stock is available at a good price, discounted to intrinsic value.

Think of this final principle this way . . . let’s say you’re heading to the car dealership to buy a new car. As you walk out onto the lot you know that the price you may have to pay is the sticker price on the car. The sticker price is what the market is currently valuing the car for. Now, if you were buying this car would you rather pay above sticker price, at sticker price or below sticker price? The answer should be a no brainer, you would want to pay below sticker price . . . the lower the better!

That is what principle four is all about. It’s about finding stocks that are currently trading below what the sticker price (market price) says they are worth. If we’re able to find stocks that are trading below their intrinsic value (sticker price) that have the other three core principles then we would have the formula for a sound stock investment.

If we find a stock that has the first three principles that we are looking for but is not trading below its “sticker price” then we will wait. Investors must know that the price at which you pay is a critical piece of investing. If you get this wrong then the investment will have a hard time making money.

Putting it all together

Here at Iron Gate Global we call ourselves probability investors. We want to make investments that have a higher probability of making money than losing money. When all four of those principles align then the probabilities of making money increase. That’s not to say that it guarantees that we will make money, but the probability of making money increases. It may take us hours, days, weeks or sometimes months to ensure that these probabilities are on our side, but when they are you can expect us to take advantage as any investor would.