K J HARRISON
INVESTORS

OUR PROPRIETARY FRAMEWORK EXPLAINED

This article, created from a series of our monthly letters to clients in 2001, explains our overall philosophy and process. “CISSEMT” is our proprietary framework, if you will, against which all KJ Harrison investment decisions are measured.

C (Catalyst)

As a value-oriented buyer, we try to buy companies that trade at a discount to what our estimate of the private market value of the company is. Thus, if we can buy a one-dollar bill 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.

But, we have discovered two potential flaws to this approach, and this has cost us over the years. First, company valuations can remain cheap for years, exceeding our client time frames as well as eroding the rate of return that we ultimately earn. Second, if we are purely price oriented, we can end up owning too many “orphaned” companies that are of little relevance to the investing world.

To improve our process, then, we search for a potential catalyst (or “C”) that will accelerate our rate of return. In some cases, the catalyst is easy—as in the case of oil service stocks. All you need is for the commodity price to rise; then, the whole sector rises, as there is more cash to purchase oil services and equipment.

In 2000, Henry Schein was our biggest position. It scored on all elements of “CISSEMT,” including the “C.” This idea had two potential catalysts: first, the resumption of growth from the re-engineered sales force; second, the potential sale of the Company, by the Schein family, in the case that management failed. As it turned out, the business improved and the market rewarded us handsomely.

In other situations, catalysts need to be found. Governance in some companies is extremely poor, and activist activities can serve as a catalyst. And we expect to participate in such activities from time to time. An example of this occurred when we persuaded Templeton to “open up” its Emerging Markets closed-end fund. While the typical open-ended fund provides daily redemption rights to investors, its distant cousin, the closed-end fund, is listed on an exchange and provides no redemption rights other than by selling through the market. Consequently, these inferior funds tend to trade at a discount to their net asset values. In the case of Templeton, we purchased units of the closed-end fund at approximately $9, when the net asset value was $13. After a few months of meetings, they allowed us to realize the net asset value. This is a great example of a catalyst.

I (Important)

On our CISSEMT theorem, “I” stands for Important Company. We look for companies that have a unique market position or unique assets of some type. Thus, we focus on industry leaders, or companies in oligopolistic environments, as opposed to small, marginal players. The reasons for this are manifold. First, leaders tend to have significant advantages, usually on both the revenue and cost sides. Second, undervalued leaders are attractive takeover targets for strategic acquirers. And, third, institutional investors will focus on such leaders in any market environment, whereas tertiary players tend to get ignored for long periods of time in poor markets.

Some industry leaders are controversial, however. We have owned Air Canada three times in the past 10 years. Each time, we were roundly criticized (too many clients must have had their luggage lost!). Company earnings have been highly volatile, but we made good profits every time. We could see that Air Canada was building an insurmountable lead over Canadian Airlines while also developing a “stealth” monopoly. Finally, in 1999, Canadian Airlines fell and Air Canada rose as the investment community recognized the company’s monopolistic attributes.

By staying in important companies, we believe we will have a higher quality portfolio—one that will attract the liquidity necessary to make our returns. This discipline has continued to enhance our quality over the years.

S (Secular)

“S” is for Secular, which refers to a multi-year trend versus a short-term, or cyclical, trend. Secular trends are often due to demographic factors or the reversal of longstanding industry trends. For example, oil drilling dried up after 1985, due to overbuilding in the 1970s (the Dome years). Then, beginning in 1995, a new secular up-trend began.

Value-oriented buyers (ourselves included) have too often bought businesses that were cheap—but with a lousy secular trend. Moore Corp. is a classic example; several years ago, it was extremely cheap. The investment did not work, as the core demand for its products and services has since been in dramatic decline. But, contrast Moore with Land’s End. Land’s End is a dominant direct merchant that has put its catalogues on the Internet. In doing so, it has made an already efficient operation even more efficient. Moreover, as Internet commerce grows, Land’s End has a tremendous secular edge. Henry Schein was another example of a positive secular trend: the core demand for dental services is growing rapidly as baby boomers require caps and crowns, and other restorative procedures.

We want to invest in companies that have great secular trends, because the underlying demand will enhance the growth of the Company and institutional interest in its services. Positive secular forces go a long way in defining great business opportunities. The best management team in the world could not save the “buggy whip” companies! Thus, our biggest commitments will be to businesses that have a positive secular trend.

S (Score)

In 1994, we adopted the scoring discipline. (A well-known U.S. money manager applies it very successfully, and we adapted it for our use.) It has helped us a great deal in avoiding companies with bad balance sheets or companies that were not yet cheap enough.

In essence, we analyze all companies on a variety of important criteria. We look at valuation parameters, growth rates, valuation ranges, and subjective factors such as management and neglect. We then calculate an aggregate score based on the sum of these elements.

Using this system is not a panacea, but it has kept us out of bad balance sheets and forced us to wait for companies to reach historically outstanding price levels. Indeed, to score a 60 on our system is tough! But, as we often say, if we only need 10 companies out of 10,000, the Score system helps us to quickly discard (or pursue) potential ideas. In short, the company has to be very cheap and very good.

E (Expectancy)

Expectancy is a rather pretentious expression for risk/reward. If expectancy is 10, we mean that the investment has $10 of upside against $1 of downside. We are looking for investments that offer profoundly good risk/reward. At $15, we believed CDI to have $2 of downside and $25 of upside. A 12.5 expectancy rate is enormous given the other attributes of the investment.

We would admit that baldly saying "CDI has $2 of downside" overstates the science. Therefore, we look for historic pricing and other factors in determining reasonable estimates of downside risk. If we follow our "S-Score" process, we should be buying at historic lows, which itself limits risk.

High expectancy is important for our larger commitments. In 1999, when Prudential Steel was $6, we felt that the stock had $1 of downside and $20 of upside. A rate of 20:1 is enormous, and we made Prudential our biggest investment.

In summary, a high "E" is a must in terms of our investing decisions. It's a mathematical way to find incredibly good risk/reward investment opportunities.

M (Management)

Assessing management is never easy. It requires a balanced review of financial track record, strategic success, philosophy, character, and passion.

We prefer situations where management has a significant financial risk—preferably, a large portion of their net worth tied up in the company. This ensures alignment with other owners, particularly important in realizing value, potential sales, etc. We dislike it when management are option holders only, and we avoid situations where a company has over-issued options to management. Management should think like owners, avoiding empire-building and other behaviours that might act against us as owners.

Picking the "right horse" is not easy, and it is probably as much art as science. We like to talk to past employees, competitors, and past employers, in an effort to understand the competence and character of the key team. We definitely like to "kick the tires" and visit companies, which affords us a real sense of the business texture.

Likewise, judging past successes is not as easy as simply looking at the financial results. A balanced measure of financial success, organization building, and tough strategic choices is 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.

At the end of the day, we want to buy an honest, owner-oriented management team that is regarded as best in its industry. Such a rare recipe, when coupled with an attractively priced franchise, invariably represents a good opportunity.

T (Technical)

The "T," or Technical, element is tricky. Value investors get extremely excited when we identify dollar bills trading for 50 cents; they tend to jump right in. Often, though, the company will get even cheaper—i.e., as we end up buying too early. We call this "catching a falling knife." Cinram, circa 2001, was a good example of this. On the selling side, we tend to sell once the company goes back to $1, but such a company will often go back to a premium in line with its private market value.

To improve upon these execution issues, we try to wait until a stock has moved into stronger hands and until the momentum-type investors are gone. And as a stock "breaks out" based on improvement in its business, we try to add to the position.

Finally, as the company hits fair value, we try to "scale sell": we keep part of the position as momentum investors take it increasingly higher. This last piece is particularly difficult for value-oriented investors. For the most part, we distrust the market and have trouble holding assets that appear to be getting expensive.

We have greatly improved our execution skills over the years; but, there's always room for further improvement. In many cases, we can wait until stocks begin to be accumulated by strong, long-term owners. This reduces the "falling knife" risk. As we learn more about the position, we get more comfortable, and we can add to the position as it begins to move higher. We will continue trying to get it more "right." That said, however, we must remember that the "T" part of CISSEMT is not nearly as important as the "CISSEM."