A checklist to overcome human weaknesses in investing

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Have you ever wondered why airline pilots have checklists and go through them carefully prior to take-off. It is because when the risk is high it is always good to have a checklist.

Since investing exposes one to significant risk of wealth destruction, using a checklist helps one overcome the weaknesses inherent in human nature, and prevents investors from making impulsive investment decisions.

Here are seven groups of questions to ask yourself before making an investment.

1. Do I understand the company's business, its business model and its strategic positioning? Math can be great but if someone does not understand the business, they set themselves up for failure as an investor. Some questions to ask in particular: What is the company's business risk? Is the industry or sector attractive? How well is the company positioned strategically in the industry? What is the competitive situation in the industry and how does the company fit within the industry? Are there barriers to entry? Who are the key players in the industry and how does the company compare with the dominant player in the industry?

2. Do I understand the company's profitability? Are there any trends unfolding on the positive or, more importantly, on the negative side of the company's profitability? Is the company's operating margin high and stable or is it rising or falling, and why? Does high revenue growth eventually show up on the income statement in the form of profits? Is high profitability passed along to shareholders in the form of dividends and dividend increases?

3. Do I understand the company's right side of the balance sheet? Is the company conservatively financed? Is the company's total debt to capital in line with the industry norm? Is interest coverage at least about 5X? Does the company have enough cash flow to pay off long-term debt as it matures – long-term debt to cash flow should not exceed 3X. What does the maturity schedule of long-term debt look like?

4. Is the company managed well? Is the CEO a good operator? Both quantitative and qualitative analysis of management is needed. Calculating various financial ratios and comparing them to the company's peers is a good starting point. In particular, one needs to ask the following questions: Does management understand the company's business and the industry dynamics? Does management have the right education, background and experience to understand the business and manage the company? Do they tend to revise financials over time and occur many non-recurring charges? What is actual performance versus management projections? What is management's record in asset allocation? Does management hold a lot of excess cash? Do they make unrelated acquisitions? Do they overpay for acquisitions or buy back shares at high multiples? Is their compensation package excessive? Are there good internal training programs and well-thought-of and clear succession planning initiatives?

5. Are there short-term catalysts that may impact the company and its value? Has something transpired that caused the stock price decline? Is this a bad quarter and one-time event (a temporary problem) or it is something of a more permanent nature? Are there any coincidental events that will probably not be repeated in the future? Are there any activist investors sniffing around the company?

6. What is the company's valuation? Does the stock seem to be undervalued? Looking at price-to-earnings ratio (P/E) or price-to-book-value ratio (P/B) is a good starting point. Are P/E and P/B ratios less or equal to 13-14x and 1.2-1.3x, respectively. For more sophisticated investors: What is the company's intrinsic value, over and above focusing only on low P/E or P/B stocks.

7. Could investing in a stock be a value trap? A value trap is a stock that looks like a bargain, based on key valuation metrics such as P/E or P/B, but it falls further in price and fails to recover within a value investor's investment horizon of three to five

years and at worst goes bankrupt, either because of a fundamental shift in the company's business or because of changes in the environment in which the company operates. The changes are not business cycle related, but instead they are secular, structural and mostly permanent. Unlike common belief, the value trap reference applies to more than the case of a company in a dying industry. Bad companies (i.e., companies whose organizational structure is convoluted and whose strategy is complex even when dealing with small problems), bad management and bad strategies could also result in value traps under certain circumstances. In general, companies with a Piotroski F-Score (a measure of a company's financial strength) which is less than or equal to 2 and an Altman Z-Score (a measure of the the likelihood of bankruptcy) of less than 1.8 should be avoided.

The above checklist should be followed with patience and discipline. While nothing is guaranteed, having a disciplined investment approach and a check list will go a long way in helping investors achieve their long-term goals.

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