

# The Rule #1 Approach to Finding Wonderful Companies

By Wayne A. Thorp, CFA



Warren Buffett, arguably the most famous investor in the world, believes there are only two rules to investing:

- Rule #1: Don't lose money, and
- Rule #2: Don't forget rule #1.

These rules serve as the premise for a new book by Phil Town entitled "Rule #1" (Crown Publishers, 2006).

Town, a former Green Beret and river guide turned investor, believes that individuals can follow Buffett's Rule #1 of investing by investing in wonderful companies at attractive prices. Following the principles of Rule #1 Investing, Town claims to have turned \$1,000 into \$1 million in five years.

AAII has developed a new screen based on Town's methodology as outlined in his book. The screen is part of the AAIL Stock Screens series. On a monthly basis, AAIL.com lists the companies passing the AAIL Stock Screens, and tracks their performance in hypothetical portfolios. [If you are interested in a detailed discussion of developing this screen with a computerized stock screening service, especially with *Stock Investor Pro*, you may wish to read the article in the September/October 2007 issue of *Computerized Investing*.]

## The Philosophy

Town believes that many individuals have been "scared off" from investing their own money. Instead, they choose to invest their money with professional money managers, typically in the form of mutual funds.

According to Town, this has come about because the financial services industry perpetuates three myths to protect their business:

- 1) You have to be an expert to manage money;
- 2) You can't beat the market; and
- 3) The best way to minimize risk is to diversify and hold for the long term.

However, Town feels that the Internet "has changed everything," and that today individual investors can find accurate and timely information on-line, often for free, which eliminates the need for a professional money manager.

In addition, he feels that individual investors are better equipped to react to the market, given that they do not influence the market with their buys and sells.

Town points out the profound impact mutual fund managers have on the overall market and on individual stocks: With trillions of dollars under their control, they effectively are the market.

As a result, in Town's opinion, investing in a large, diversified mutual fund actually increases an individual's investment risk: If the market were to fall sharply, investors would start withdrawing money from mutual funds, which, in turn, would force the managers of these funds to sell stock to cover withdrawals, adding further downward pressure on the market.

Given these circumstances, Town believes that individual investors following the Rule #1 Investing approach—buying a few choice businesses in different sectors at attractive prices—should be able to outperform with reduced risk.

## Rule #1 Investing Criteria

In "Rule #1," Town outlined several specific guidelines to

## Wonderful Businesses at Attractive Prices: The 4 Ms

In order to conform to Buffett's Rule #1 of investing—don't lose money—Rule #1 investors buy "wonderful businesses at attractive prices." To find these wonderful companies, Town follows the "Four Ms": meaning, moat, management, and margin of safety.

### Meaning

Town believes that companies that hold "meaning" for an individual are those that you are willing to make your sole means of financial support for the next 100 years. In order to make such a significant commitment, it is vital to do your homework regarding the company so you feel comfortable with what the company does.

However, this does not mean you need to have intimate knowledge of the company's business model. Instead, Town borrows another page from Buffett and suggests investing in companies you already know—consider what you enjoy doing, what you are good at, and where you earn or spend your money.

### Moat

The term "moat" has gained in popularity in the investing lexicon

over the last several years. Simply put, a moat is a barrier to entry for would-be competitors of a company. A wide moat, in general, protects companies in some way from competition. Because of their wide moats, such companies also tend to be well-known and among the top companies in their industries.

In addition, wide moats tend to insulate companies from inflation, meaning they can raise their prices as costs go up without fear of losing market share to lower-priced alternatives.

Town identifies five moats: brand, trade secrets, tolls, switching costs, and price.

Companies with strong brands offer products that consumers are willing to pay a premium price for because they know and trust the company. Town cites Apple and eBay as examples of companies with strong brands.

Trade secrets can also create moats for companies—they prevent companies from competing against them because the ingredients of the product, or the means of production, are secret. These secrets can include, for example, the secret recipes of Coca-Cola or Kentucky Fried Chicken. Drug companies with patent protection are another example.

Town describes "toll-bridge" com-

panies as those with exclusive control of a market—in effect, a monopoly. Therefore, companies can collect a toll from those wishing to use their products or services. Town cites utilities and advertising and media companies as examples of toll-bridge companies.

Some companies have moats because the costs of switching to competitors' products or services are just too high in terms of time, money, and aggravation. Town offers Microsoft as a prime example. Despite the well-publicized problems with the Windows operating system, it still enjoys overwhelming market share over the more stable and secure Mac OS from Apple. For most, this is because of the cost and hassle involved with switching operating systems.

Finally, a company has a price moat when it can price its products so low that no other companies can compete. Given its massive purchasing power, Wal-Mart is a well-known example of a company with a price-based moat.

To find companies with wide, sustainable moats, Town uses the "Big Five" numbers (see below).

### Management

Beyond finding companies that hold meaning to us, we also want people we

follow when trying to identify wonderful businesses with attractive prices:

- 1) **The "Big Five":** Town believes in searching for companies with wide moats (see sidebar above), but it is important that the wide moat be *sustainable* going forward. To find companies with wide sustainable moats, Town looks for the Big Five, which should **all** be equal to or greater than 10% per year for the last 10 years:
  - return on invested capital (ROIC);
  - equity (or book value) per share;

- earnings per share growth;
  - sales growth; and
  - free cash flow growth.
- 2) **Manageable Debt:** Rule #1 investors are trying to find stable, predictable companies. For companies saddled with a high debt load, a downturn in the economy or any other "blips" could force the company to sell off assets to cover its debt obligations, which could have a negative impact on the company's future. Ideally, Town would like companies to have no debt, but he is more interested in whether a company can pay off its

- debt quickly. As a rule, then, he feels that a company has a "reasonable" level of debt if its current annual free cash flows can pay off its long-term debt obligations within three years: In other words, long-term debt divided by annual free cash flow is less than or equal to three.
- 3) **Margin of Safety:** After finding wonderful companies, the next step is to find those that offer a sufficient margin of safety. Town does not want to pay more than 50 cents for every dollar of a company's value. He estimates a company's fair value by calculating what he calls the

can trust and respect running them. This is where the third M, management, comes into play. Here, Town looks for owner-oriented leaders.

In Town's view, an owner-oriented CEO has his personal interests directly aligned with the owners of the company—the shareholders.

As the Internet bubble illustrated, company-issued stock options can sometimes create a divergence between shareholder interests and executive interests. Therefore, all else being equal, Town believes that CEOs who do not accept stock options as part of their compensation package are more apt to be owner-oriented.

Town offers another easy way to learn about the person running a company—read their annual letter to shareholders. While not every chief executive is as candid in his annual letter as Warren Buffett, Town doesn't want a CEO to sugarcoat what happened with the company over the last year. He believes that owner-oriented CEOs are willing to step up and tell us what went wrong over the last year, whose fault it was, and what they hope to do about it.

Another item Town mentions during his discussion of management is insider trading. While insider-trading

statistics are, at best, an imperfect indicator of company troubles, investors can glean some potential insight from them. Corporate executives can sell their shares for a number of reasons, most of which are completely innocuous in nature—tax purposes, estate planning, portfolio rebalancing, etc. Therefore, it's not a good idea to sell your stock in a company just because some insiders are selling theirs.

What is much more important is the magnitude of the selling. Town warns that if you see several executives selling a large portion of their holdings, it may be time to head for the door. Keep in mind that you may need to go back several months to piece together a pattern of insider selling. If a company executive is defrauding the shareholders, it is highly unlikely she would sell all of her shares at once, especially if she has substantial holdings in the company.

#### Margin of Safety

Just because a company is a wonderful business doesn't necessarily make it a wonderful investment. While Town points out he is not a value investor, he stresses the importance of buying a company with a margin of safety—his fourth M.

uses charting and technical analysis to determine the right time to buy. In addition, he uses these same tools to trade his Rule #1 stocks—selling when they become overbought and buying when they become oversold.

Ultimately, however, he believes that there are only two instances when you should abandon a Rule #1 company for good:

- 1) When the business ceases to be wonderful, or
- 2) When the market price is above the sticker price.

Town believes that the biggest reason why a once-wonderful business

According to Town, this means buying a dollar of value for no more than 50 cents, a common practice of the father of value investing, Benjamin Graham. Such a margin of safety, in theory, serves as a safeguard in case your wonderful business turns out to be not-so-wonderful.

In order to arrive at Town's margin of safety (MOS) price, an investor must first determine the "true" value of the company—the "sticker price." From there, the MOS price is merely one-half the sticker price.

It is important to note that a number of assumptions go into deriving this sticker price. The most significant is that the growth the company is currently experiencing will continue for the next several years. This is another reason why Town looks to buy when the current stock price is at least 50% lower than the sticker price. This provides some protection in case the underlying assumptions used in calculating the sticker price do not hold up.

Our screen looks for companies with a current stock price that is no more than 50% of the sticker price (see the box on page 10 for an example of how to calculate sticker price).

ceases to be wonderful is when its moat is threatened. The other reason, according to Town, is when the CEO stops being on the shareholders' side. Over time, problems with the company will appear in the Big Five numbers. When they do, it is time to sell.

When the stock price reaches the sticker price, it no longer provides a margin of safety and it is time to sell. However, it should also mean that you have a nice gain since you bought it at less than 50% of the sticker price.

For Rule #1 stocks, Town sells because their price reaches the sticker price, but he does allow for a violation

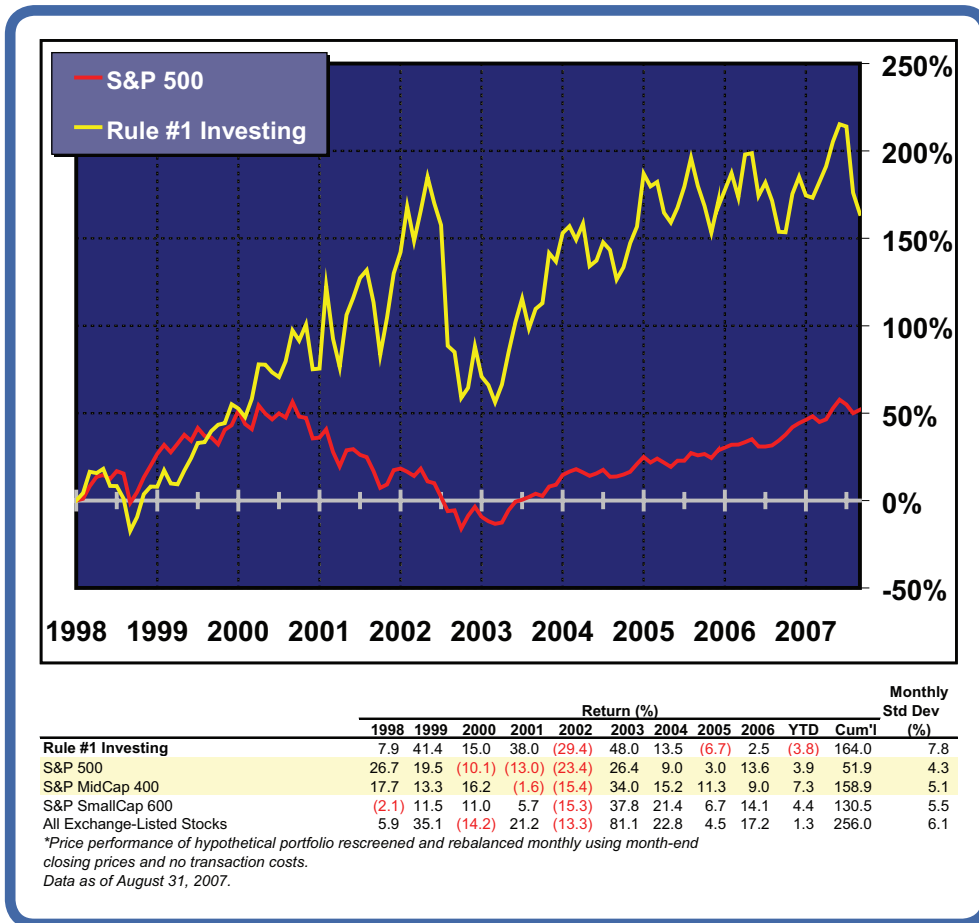
"sticker price." Town then only buys those companies whose stock price is no more than 50% of its sticker price.

- 4) **Adequate Liquidity:** Town warns against attempting to buy or sell illiquid stocks. Ideally, he would like to see a stock have an average daily trading volume of at least 500,000 shares.

#### Monitoring & When to Sell

Once Town finds a wonderful company with an attractive price, he does not immediately buy its stock. He also

**Figure 1. Performance of Rule #1 Investing Screen**



of his 50% margin of safety. Assuming all of the other numbers pass muster, he will buy back in when it drops 20% below the sticker price.

## The AII Screen

For the AII screen, we used AII's *Stock Investor Pro* fundamental stock screening and research database program. *Stock Investor Pro* covers a universe of almost 9,000 NYSE, Amex, and NASDAQ stocks.

Figure 1 reports backtesting results that show the Rule #1 Investing screen outperformed the S&P small-, mid-, and large-cap indexes since the beginning of 1998. However, it only has a slight advantage over mid-cap stocks and has greatly underperformed the typical exchange-listed stock over the same period. Between January 1998 and the end of August 2007, the Rule #1 Investing screen returned 164%. By comparison,

the S&P 500 index gained 51.9% over the same period.

## Profile of Passing Companies

Table 1 presents the characteristics of the companies passing the Rule #1 Investing screen as of September 7, 2007.

The Rule #1 Investing screen looks for companies with strong income statements and balance sheets that are also trading at a discount to their fair value or sticker price. Therefore, it may not be surprising that the current group of passing companies has a median price-earnings ratio (11.7) that is significantly lower than the median price-earnings ratio of 18.5 for all exchange-listed stocks.

The current passing companies, as a group, have no problem exceeding the requirement that the average annual growth rate in earnings per share be 10%

or higher. The median earnings growth rate of 79.3% easily surpasses that of all exchange-listed stocks, which is 15.4%. Looking forward, analysts expect robust growth from the current Rule #1 Investing companies, as they have a median forecasted earnings growth rate of 21.2% versus 14.6% for all exchange-listed companies.

In order for a company to pass the Rule #1 Investing screen, its current price must be no more than 50% of its sticker price—an estimate of the company's fair value. The current passing companies have stock prices, which, on a median basis, are only 25% of their respective sticker prices. In contrast, the typical exchange-listed stock has a current price that is almost 66% of its sticker price.

Lastly, the companies currently passing the Rule #1 Investing screen have not fared very well relative to the overall market over the last year. The companies have underperformed the S&P 500 on a median basis by 11.5% over the last 52 weeks, while the typical exchange-listed stock has underperformed the S&P 500 by 4% over the same period.

## Passing Companies

Table 2 lists the eight companies passing the Rule #1 Investing screen as of September 7, 2007. We ranked these companies in descending order by their five-year average return on invested capital (ROIC). Town says that if he were to choose only one of the Big Five numbers, it would be ROIC, since in his opinion it indicates how well the company is being run.

Odyssey Re Holdings, a casualty and property insurance provider, barely cleared the 10% hurdle for average ROIC at 10.6%. For 2005, the company had a return on investment of -5.5% after suffering significant losses from hurricanes Katrina, Rita, and Wilma. In

2006, however, the company was able to rebound to post its highest ROIC over the five-year period of 19.6%.

Northwest Airlines owned Pinnacle Airlines Corporation, the parent company of Pinnacle Airlines and Colgan Air, until 2003, when Pinnacle went public with an initial public offering. Prior to Northwest's transferring control, it entered into two non-cash transactions whereby Pinnacle "paid" Northwest \$215.5 million in dividends. As a result, Pinnacle's retained earnings fell from \$476.9 million in 2002 to a deficit of \$133.6 million at the end of 2003. In turn, the company's shareholder's equity was deficient \$48.4 million. However, the company's earnings performance since 2003 has allowed it to expand its equity to the point where it meets the growth requirements for this screen.

While not part of the actual screen, we did include the 10-day average trading volume of each of the passing companies in Table 2. Town says he would like to see average daily trading volume of at least 500,000 in stocks he is looking to buy. However, many daily trading volume statistics, including those in *Stock Investor*, tend to be erratic because they only cover the last 10 trading days.

Based on Reuters' data in *Stock Investor*, Travelzoo has the lowest average daily trading value among the passing companies at 176,000 shares. However, Google Finance lists Travelzoo's average

**Table 1. Rule #1 Investing Portfolio Characteristics**

<b>Portfolio Characteristics (Median)</b>	<b>Rule #1 Investing Stocks</b>	<b>Exchange-Listed Stocks</b>
Price-earnings ratio (X)	11.7	18.5
Price-to-book-value ratio (X)	3.93	2.03
Price-to-sales ratio (X)	3.05	1.84
Dividend yield (%)	0.0	0.0
EPS 5-yr. historical growth rate (%)	79.3	15.4
EPS 3-5 yr. estimated growth rate (%)	21.2	14.6
Price as % of sticker price (%)	25.0	65.8
Market cap. (\$ million)	1,542.8	464.1
Relative strength vs. S&P (%)	-11.5	-4
<b>Monthly Observations</b>		
Average no. of passing stocks	13	
Highest no. of passing stocks	35	
Lowest no. of passing stocks	2	
Monthly turnover (%)	26.7	

daily trading volume at 335,000 shares and Yahoo! Finance has it at just over 182,000 shares. For this reason, it is a good idea to consult multiple sources for this information.

We also list the number of insider sell transactions over the last six months for each of the Rule #1 Investing companies, although we did not use this in the screen either. Town warns against investing in companies where insiders are selling significant portions of their holdings, and the data in Table 2 tells us whether there is need for additional investigation.

First Marblehead has had the highest number of insider sells, with 43. However, a single director made the vast majority of these sales. Among key executives, the CFO sold 1,548 shares in August but still holds over 93,000 shares. In addition, between May and August of this year, the company's chief administrative officer exercised options for 12,000 shares and sold 3,810 shares. These were the first shares she had held over the last two years, so these sales do not appear to be significant.

Finally, in order to provide what he considers to be an adequate margin

**Table 2. Companies Passing the Rule #1 Investing Screen**

<b>Company (Exchange: Ticker)</b>	<b>ROIC 5-Yr Avg (%)</b>	<b>5-Yr Avg Annual Grth</b>				<b>EPS Grth Est (%)</b>	<b>LT Debt-to-FCF (X)</b>	<b>Vol 10-Day Avg (000s)</b>	<b>Insider Sell Trades (X)</b>	<b>Price as % of Sticker Price (%)</b>	<b>Description</b>
		<b>Equity (%)</b>	<b>Sales (%)</b>	<b>EPS (%)</b>	<b>FCF/ Shr (%)</b>						
First Marblehead Corp. (N: FMD)	39.7	114.4	84.0	89.8	110.2	36.1	0.08	761	43	2.1	education lend servs
Travelzoo Inc. (M: TZOO)	33.7	110.1	62.7	122.1	102.8	20.0	0.00	176	0	30.4	Internet media co.
Pinnacle Airlines Corp. (M: PNCL)	32.0	11.7	32.5	40.4	22.7	20.0	0.07	213	22	27.2	regional airline
NutriSystem Inc. (M: NTRI)	28.8	110.7	88.6	160.1	176.3	23.5	0.00	1,195	16	22.3	weight mgmt food
InterDigital, Inc. (M: IDCC)	27.6	35.5	55.6	68.8	202.9	23.3	0.01	895	1	24.3	digital wireless tech
Palomar Medical Tech (M: PMTI)	25.7	97.5	49.9	50.0	35.2	22.4	0.00	196	0	16.1	laser cosmetics
RenaissanceRe Hdgs (N: RNR)	14.1	18.2	33.1	31.2	16.1	12.3	0.65	390	32	25.6	reinsur & insurance
Odyssey Re Hdgs Corp. (N: ORH)	10.6	20.5	23.1	121.8	69.1	14.0	0.92	282	4	45.9	reinsur underwriter

Exchange Key: M= NASDAQ National or NASDAQ Small Cap Market, N= New York Stock Exchange  
Source: AAI's Stock Investor Pro/Reuters Research, Inc. Data as of September 7, 2007.

## What It Takes: Rule #1 Investing Criteria

- Include only companies listed on the New York, American, or NASDAQ exchanges
- Exclude foreign companies trading as ADRs on U.S. exchanges
- The average return on invested capital over the last five years is at least 10%
- The average annual growth rate in equity over the last five years is at least 10%
- The average annual growth rate in earnings per share from continuing operations over the last five years is at least 10%
- The average annual growth rate in sales over the last five years is at least 10%
- The average annual growth rate in free cash flow over the last five years is at least 10%
- The ratio of current long-term debt per share to current annual free cash flow per share is no more than three
- The current stock price is no more than 50% of the company's "sticker price," an estimate of fair value

of safety, Town only initially buys company's whose current stock price is less than or equal to 50% of its sticker price. See the box below for an example of how to calculate the sticker price.

Table 2 shows the current stock price as a percentage of the company's sticker price. These values range from a low of 2.1% for First Marblehead to a

high of 45.9% for Odyssey Re Holdings, just below the 50% cut-off.

### Conclusion

Town's approach of finding companies with solid income statements and balance sheets trading at a perceived discount has been the cornerstone of numerous successful investment strategies.

However, even if a company meets all of the Rule #1 Investing requirements, it does not mean you should automatically buy it.

Stock screening is only a starting point in the investment process. Ultimately, you want to identify stocks that match your investing tolerances and constraints before adding them to your investment portfolio. ▲

## Calculating the Sticker Price: An Example

- 1) EPS-Continuing 12m (\$/shr) 3.94
  - 2) Rule #1 Growth Rate 36.1%  
*For sake of conservatism, Town uses the lower of the historical equity (110.0%) and estimated EPS (36.1%) growth rates.*
  - 3) Future EPS (in 10 years) \$85.92/share  
 $EPS_{12m} \times [1 + (\text{Rule \#1 Growth Rate} \div 100)]^{10} = 3.94 \times [1 + (36.1 \div 100)]^{10} = 85.92$
  - 4) Estimated future PE (X) 72.2  
*For sake of conservatism, Town uses the lower of the default P/E (72.2) and the average historical P/E (na).*  
Default P/E = (Rule #1 Growth Rate  $\times$  2) = 72.2  
Avg. 5-Yr Historical P/E = na (*Company has not been trading for five years.*)
  - 5) Future Market Price \$6,203.42  
Future EPS  $\times$  Estimated future P/E =  $85.92 \times 72.2 = \$6,203.42$
  - 6) **Sticker Price \$1,533.39**  
Future Market Price  $\div [1 + (\text{Minimum required annual return on investment} \div 100)]^{10}$   
 $\$6,203.42 \div [1 + (15 \div 100)]^{10} = \$1,533.39$
- Current Stock Price (9/7/2007 close) \$32.19  
Current Price as % of Sticker Price 2.1 *Must be 50% or less to provide adequate margin of safety in order to buy.*

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