HUNTING FOR HUNDRED BAGGERS: WHAT STOCKS SHOULD – AND SHOULDN'T – GO IN A COFFEE CAN PORTFOLIO

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Ask Geoff a Question of Your Own

From a "100-bagger" type perspective, the criteria are pretty simple: 1) Is it a small stock (probably a micro-cap, definitely a small-cap)? - We're talking <$300 million market cap probably, but certainly like $1 billion or so - not multi-billions 2) Does it have a market multiple or lower (so, say most P/Es today are 18 or whatever - is it 18 or less, not above) 3) Does it grow faster than most businesses, the economy, etc. 4) Is it self-funding? There are other things you could look for in a stock that would be good pluses to have. But, those 4 criteria are the really important ones for whether something is immediately disqualified as potential buy and hold forever type stock. Basically, it ***HAS*** to be small (if it's in major indexes like S&P 500 - it's not a buy and hold forever stock), it can't have a multiple that will contract while you own it (so, it doesn't have to be a "value" stock, but it can't be especially high priced), it has to have strong growth, and then it has to be able to fund a lot of or all of that growth (it shouldn't be issuing a lot of shares, for example). You could make this into a 4-point checklist to make decisions on the stocks you own.

Once you've decided a stock might be a possible coffee can portfolio candidate – it passes the screen of: small market cap, not high P/E, good growth, self-funding – then you can start on the more qualitative checklist.

You have to ask questions like:

1) Is this stock in one of my areas of expertise?

2) Is this an above average industry to be in for the long haul?

3) Is this an above average company within that industry?

4) Is this run by an above average management team?

5) Am I paying a below average price for this business?

Those are the 5 questions I'd ask when deciding whether to add a potentially promising stock to your coffee can portfolio. Honestly, the most important is #1. You want to avoid businesses that are outside the areas where you exercise your best judgment. For example, if someone brought me 4 stocks that had the exact same financial histories and prices but one was in finance, one was in entertainment, one was in medicine, and one was in semiconductors - I would immediately decide not to buy the medical or semiconductor companies because my judgment in those areas is poor.

I would consider the finance and entertainment businesses though. This is because my judgment in the areas of finance and entertainment is "expert" enough that I know it's better than most buyers and sellers of those stocks. I will, of course, still make mistakes. You'll make mistakes from time to time in all areas. But, you'll make fewer mistakes in your areas of expertise. For me: finance and entertainment are areas of expertise – medicine and semiconductors aren't. For Buffett: his judgment of newspapers, for example, was always excellent. He had good judgment in insurers too. Insurance, banking, media, advertising, and consumer brands together probably account for more than 100% of Berkshire's value creation (I wouldn't be surprised if everything else Buffett has done – at least in his Berkshire years – has been neutral to value destroying when we take opportunity costs into account). So, if you know certain industries better than others - stick to those industries. And the, within those industries, you have this 9-point checklist to apply:

1) Is it a small enough stock?

2) Is the multiple low enough?

3) Does is grow fast enough?

4) Is it self-funding?

5) Is the industry within one of your areas of expertise?

6) Is it an above average industry to be in long-term?

7) Is this an above average company in that industry?

8) Is the management team better than most?

9) Are you paying a below average price for the business?

I actually find it easier to slightly invert questions like this. So, instead of screening "for" something – screen against it. Like ask: Is this stock too big to make sense in a coffee can portfolio? Is this P/E multiple too high to avoid multiple contraction while I own it? Is the growth rate here too slow to ever produce a 100-bagger? Is the company issuing too much stock, borrowing too much, etc. to compound shareholder money like I need it too? Is this an industry I don't understand well enough? What's the evidence this is a below average industry over the long-run? What's the evidence this is a below average company within its industry? What's the evidence this is a below average management team? And, finally, am I paying a higher than average price for this stock?

Basically, if you can get past all 9 questions without any clear "black marks" against the stock – that's probably a pretty great stock to consider investing in. In fact, a stock that gets through all 9 of those points, doesn't need to score amazingly on any one point. It doesn't have to have a P/E of 5 or growth rate of 25% or ROIC of 100% or the most amazing management team in the industry. As long as it really doesn't seem to fail any of those 9 tests – you probably won't regret buying the stock, and you might get lucky and have a big upside. But, if a stock passes all 9 of those tests – the downside should be pretty limited.

I didn't mention things like Z-Scores, debt-to-EBITDA ratios, etc. Generally, a consistently growing company in a good industry with a good management team that has always mostly funded itself from its own retained earnings is not going to present any sort of financial risk. But, that is the one other thing to keep in mind: “catastrophic risk”. I can’t really put that point into a clear checklist item. But, it may be appropriate to pass on a stock that has a serious risk of extinction even if it passes all 9 other checklist items. The cases where this would occur though are really, really rare. And, honestly, most instances where the market perceives an existential risk to a stock that passes all 9 of those checklist items are imagined. They are usually just a brutal temporary problem that will pass. Truly unsolvable problem stocks are more likely to show evidence in lack of growth, lack of self-funding, bad industry to be in long-term, weak management team, etc.

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