



CENTERSTONE  
INVESTORS

CENTERSTONE INVESTORS

# Guide to Intelligent Investing

OUR DISTINCT INVESTMENT APPROACH

*“Successful investing requires a strong dose of common sense. As a result, we approach security analysis from a different perspective. We are business analysts, not ‘equity’ analysts.”*

## MARGIN OF SAFETY AND INTRINSIC VALUE

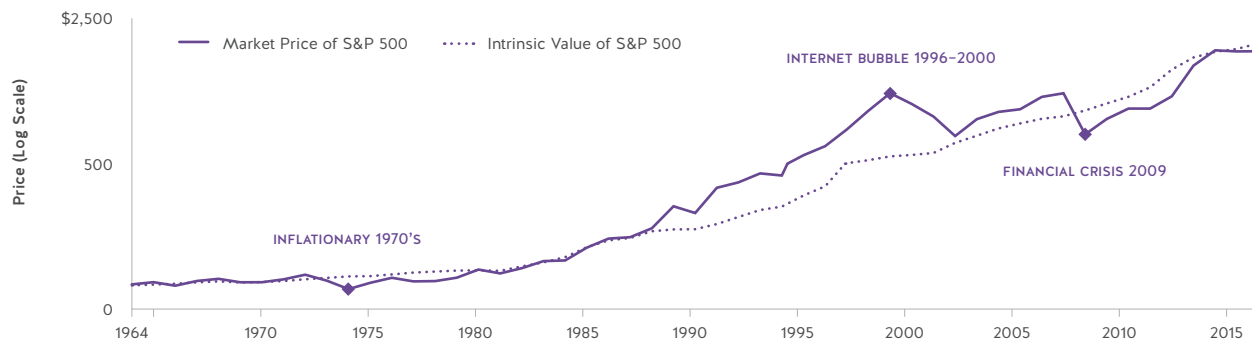
Centerstone Investors' approach to investing is built on the principles introduced by Benjamin Graham. He is often referred to as the father of value investing and his seminal book, *The Intelligent Investor*, published in 1949, is often referred to as the bible for value investors. Clearly time has passed and the world has changed, but the basic principle of seeking a “margin of safety” is valuable and timeless; it is the *centerstone* of our approach.

To understand what the concept of a margin of safety means, first one has to understand the concept of intrinsic value. Simply defined, intrinsic value refers to the price a knowledgeable investor would pay in cash to control an asset. At Centerstone, we have a long-term investment horizon and assess long-term earnings power rather than current earnings. When we invest in a security, it is often after we have determined that the market price, in our opinion, is lower than the intrinsic value, the difference being our margin of safety. Since we define risk as permanent loss of capital, a margin of safety should afford us a cushion to potentially avoid paying more for an asset than its intrinsic value.

In addition, our experience has been that intrinsic value and price do eventually converge even if they can remain apart for periods of time. To illustrate, on the following page is our estimate of intrinsic value of the S&P 500, employing our proprietary model for its calculation, against the market price of the S&P 500 dating back to 1964. Using the S&P 500 index as an example, we see first that intrinsic values are more stable than market prices, as Graham noted, and second that indeed value and price have tended to converge over time. Graham explained this tendency by saying that in the short-term, the market acts as a voting machine tallying up which companies are popular and unpopular, while over the long-term the market acts as a weighing machine by assessing the true substance of the company.

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## INTRINSIC VALUE OF S&P 500 VS MARKET PRICE OF S&P 500



Source: Bloomberg, Centerstone Analysis

## INVESTING VERSUS SPECULATION

One dividing line between investing and speculation relates to time.

By definition, investors hold for a longer period of time than speculators and investments are necessarily longer-lived affairs when compared to speculations. Some investments rely on the compounding effects of long-duration businesses and are “bought-to-own.” Only under extraordinary conditions are such companies sold. However, normal business cycle fluctuations can create opportunities in more cyclical industries as well. Provided our qualitative hurdles are met, such investments will merit consideration with an understanding that they tend not to be “bought-to-own.” The time required to allow for the prices of such companies to recover to their intrinsic values necessitates a long-term time horizon,

however, qualifying such companies as investments as well.

Another distinction between investing and speculation relates to the riskiness of the security. Our focus is on **analyzing balance sheet risk, business model durability and managements' capital allocation decisions**. In certain cases, our analysis will lead us to conclude that there is an immeasurable amount of risk in the security. In those instances, paying a low price is irrelevant because the impairment risk becomes incalculable. As a result, without an identifiable margin of safety they become more speculations than potential investments.

*“Our focus is on analyzing balance sheet risk, business model durability and managements' capital allocation decisions.”*

## SEEKING TO MANAGE RISK THROUGH BOTTOM-UP RESEARCH

Our risk management approach has several components starting with the individual securities and ending with our overall allocation to “risk assets” (defined as any non-US Treasury instrument).

In addition to assessing earnings power to determine our intrinsic value, it is also important to consider the prospective threats or opportunities that a business faces along with the quality of the management team behind the business itself. As mentioned, from a bottom-up view, our experience is that there are three key factors to focus on aside from price: **balance sheet risk, business model durability** and **managements’ capital allocation decisions**.

The future is unknown and we believe the best strategy is to make sure one can survive any conceivable future outcome. For individual securities we believe that by focusing on these three key factors, in conjunction with being mindful of price, we are more likely to succeed for our clients and attain our goal of positive real performance over a full market cycle.

### LEVERAGE

In our opinion, it is important to avoid highly leveraged businesses specifically as they tend to be more exposed to impairments of value during periods of industry or economic distress. There are many recent examples of poor balance sheet management which led to catastrophe during an economic contraction (Chrysler, Lehman, Northern Rock) and we have seen enough examples to have made this a hard and fast rule.

### BUSINESS MODEL DURABILITY

This is also key to our long-term investment approach. We focus our efforts on understanding the likelihood of a change in the earnings power of a business due to changing competitive dynamics, technological challenges and regulations, among other factors. Many businesses have seen their business values become impaired by these factors (Kodak, Tribune, Sony).

### MANAGEMENT

Finally, managements’ attitude towards their shareholders, via their capital allocation decisions, can also have an important influence on intrinsic value in our view. Some management teams have histories of poorly timed share buybacks, expensive debt-fueled acquisitions or overly aggressive accounting treatment (Enron, Parmalat, Valeant). Unless there is the prospect of a change in management, in most cases we will avoid such businesses.

## GENERAL MARKET RISK WITHIN A BOTTOM-UP APPROACH

One of the major challenges in following an intelligent investing framework is that there are and will be long periods of time when it will be difficult to unearth many securities that pass a strict set of valuation and qualitative guidelines.

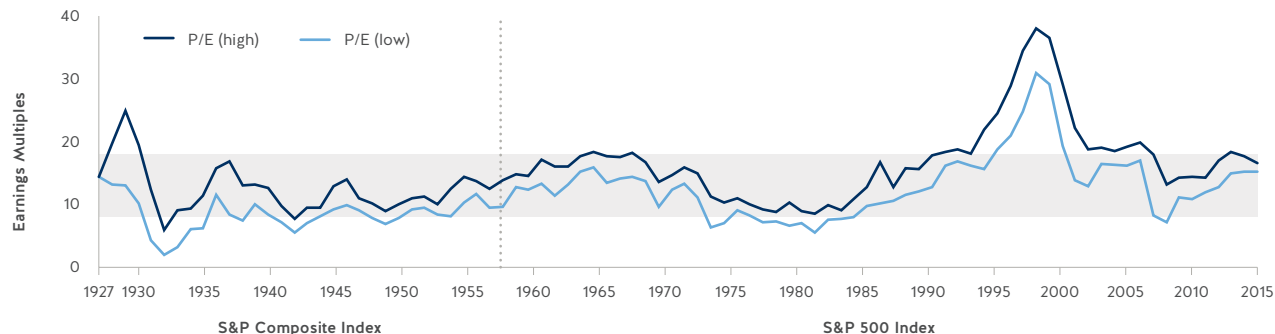
For that reason, Graham counseled to have the flexibility to hold a reserve in cash and high quality debt instruments. In environments with an insufficient margin of safety, fully invested portfolio mandates can become too exposed to the risk of loss by owning potentially overvalued securities, while a more flexible policy may help to reduce that risk.

One measure that helps us understand the riskiness of the general market is the S&P 500's Price to Earnings ratio relative to its history, illustrated below. A few things stand out. One, the uniqueness of the late 1990's bubble even in comparison to the late 1920's bubble. The second, despite the wide range of fluctuations, there has been a noticeable range of multiples when we look outside of bubble-era markets. It is not unusual for prices to range between multiples of 8x and 18x earnings. In fact, history shows

that a bubble has been required to get beyond the range. It is important for price conscious investors to understand the pricing environment. This is because in highly priced markets, the remaining low-priced securities are often justifiably cheap. By being aware of general market levels, we attempt to avoid the mistake of being too heavily invested in seemingly cheap but risky securities.

The concept of intrinsic value, combined with a long-term time horizon and the flexibility to hold reserves, are important parts of Graham's intelligent investing framework. Most important is his advice to seek a margin of safety in any potential investment. From our observations and tenure as global investors, we believe that Graham's framework, with just a few updates to accommodate for modern day realities, is more relevant than ever; it is the [centerstone](#) of our approach.

### S&P 500\* PRICE TO EARNINGS (AT HIGH AND LOW PRICES FOR THE YEARS 1927–2015)



Source: Bloomberg, Shiller Data, Centerstone Analysis

\*The S&P 500 index, formerly called the Composite Index (and later Standard & Poor's Composite Index), had been launched on a small scale in 1923. It began tracking 90 stocks in 1926 and expanded to 500 in 1957.

## CENTERSTONE'S GUIDELINES TO INTELLIGENT INVESTING

A long-term time horizon and the avoidance of permanent capital loss are the keys to a successful investment strategy



Business quality, balance sheet quality and management quality are as important as price in considering the difference between an investment and speculation

The flexibility to hold reserves is an important tool in the event that bottom-up search yields few opportunities





There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. These risks may be more pronounced with respect to investments in emerging markets.

The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value.

The Standard & Poor's 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the Standard & Poor's 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

All investments involve the risk of loss of principal.

## FIRM OVERVIEW

Centerstone Investors was founded in 2016 by highly regarded Global Value investor, Abhay Deshpande. Launched to provide our clients with a nimble and flexible, value-oriented investment approach, Centerstone is a New York-based, privately owned SEC-registered investment advisor offering niche investment vehicles. We are heavily focused on the fundamental analysis of businesses and pride ourselves on our employee ownership culture, creating alignment with our investors.



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