FP INVESTING

CANADIAN INVESTOR OUTLOOK 2013

Q&A THE MICRO VIEW

Dan Goodman, founder, CEO and co-chief investment officer, GFI Investment Counsel Ltd.

Toronto-based GFI tailors investment portfolios for families, foundations, trusts and corporations. It also operates the Good Opportunities Fund, which uses a value-oriented approach to identify compelling long and short investments and is only available to accredited investors.

Q *What's the first thing you look at when considering a stock?*
A We try hard not to use the term stock since we see ourselves as buying fractional ownership in a business. Some of the key things we look at are around the company's competitive position. One of the areas we've been focused on is obsolescence risk. To us, it's more about looking forward than backward. We have to make sure the company and the industry is not declining or shrinking. We put everything through a full-defined checklist of qualitative issues around the business.

Q *What are some of the things on that checklist?*
A It includes balance sheet sustainability or how many years of reduced earnings can the balance sheet withstand. We ask ourselves how much can we lose, what's the worst-case scenario, and what would that look like? Does the company or business have recurring revenue? We take a really close look at the operating leverage inherent in the company. If we expect a company to grow at a certain rate, what does that do to forecasted future earnings? Obviously, we're on the hunt for great operating leverage. One term we've talked about for a long time is durable competitive advantage at a fair price. What are you willing to pay for a business given that it has such a wide moat or durable competitive advantage? To us, that's critical.

Q *What are the most important valuation metrics?*
A To us, the value of anything is the present value of its future cash flow. Price-to-cash flow and interest coverage are also things we consider important, as they help us derive our discounted cash flow. They help us ensure a margin of safety. You can't overpay for free cash flow.

Q *What indicators can be misleading?*
A Earnings can be misleading, because a lot of people capitalize certain expenses. You really have to drive through that and go to cash flow. One of the things that trips people up with free cash flow and even operating cash flow is capex [capital expenditures]. They'll move parts of capex beyond cash from operations, so you really have to understand what sort of ongoirg capital expenditure the business has to outlay to continue in operation. You really have to deduct that from operating cash flow to get a better metric there.

Q *What is your sell discipline?*
A We have a very specific sell discipline based on a price. What usually happens around an earnings announcement if we're right and the company does very well is the stock rises and comes close to our sell price.It's a fluid process and we have to analyze what they just released to determine if the price should change. If future growth prospects have changed so much, maybe our price needs revision. But if nothing has changed, then we start selling as early as 85% of our defined price.

Jonathan Ratner, Financial Post