MOTIF: The Micro of Macro

The following is part 3 of our Macro Ops Trade Identification Formula (MOTIF) Series. In case you missed them, here's [Part 1](#) & [Part 2](#).

Micro Fundamentals

The name of the game in trading/investing is buying what'll *appreciate* and selling what'll *depreciate.* It's this process that creates demand.

Demand is based on narratives. Humans make decisions by pooling information into coherent and digestible stories.

The narratives for stocks in particular are dependent on earnings growth, or rather, the *belief* in future earnings growth. Investors are willing to buy shares in a company if they can create a narrative that gives cause for potential massive future earnings growth.

(Sidenote: The exception to this is the large dividend stalworth where the company's revenues and earnings growth rates are stable. In this instance the stock is valued more like a bond, which means its demand narrative is driven by cash flow and relative credit concerns — both factors that influence the the stock's ability to maintain its dividend.)

Narratives are why stocks like AMZN can trade at over 100x earnings.

Amazon's narrative is predicated on the belief that one day it will have eaten up *so much* market share and developed *such* an advanced supply and distribution platform (moat), that it'll be able to flip an earnings switch and rake in countless profits.

Whether this narrative ends up being true is anybody's guess. But the main point is that it's dependent on *strong continued sales growth*. This sales growth leads investors to believe in future earnings growth. Sales growth is the key driver of this particular narrative.

> "A great company could be a terrible investment if its price rise has already more than discounted the bullish fundamentals. Conversely, a company that has been experiencing problems and is the subject of negative news could be a great investment if its price decline has more than discounted the bearish information." ~ Jack Schwager

The key driver is the foundation a narrative rests on. If the driver changes, so does the narrative.

During the 90's tech bubble, clicks and eyeballs (web traffic) were the key driver for many companies. It was naively believed that these metrics were indicators of future earnings growth. Because of this, a powerful narrative formed that drove prices sky high. The key driver of most tech narratives today include metrics such as revenue, market share, and user growth (often at the cost of earnings).

All micro narratives tie into the belief of future earnings growth. And they're all propelled by a key driver.

Potential key drivers could be:

- Capacity (i.e. current and expected builds and tear downs of shipping tonnage, drilling rigs for oil, OPEC agreements, etc.)
- Federal Reserve forward guidance (i.e. dovish Fed leads to the belief in a perpetual "Fed Put" on markets)
- Regulation/deregulation of financial institutions driving bank stocks
- Demographics driving demand shifts
- Monthly active user numbers driving tech stocks

The majority of our micro analysis involves identifying a narrative and its key driver. The goal is to understand how long the current narrative will last. For a narrative to continue, its key driver must remain intact, which is why we must also look for catalysts that could possibly change the key driver and therefore the overall narrative.

The market is often wrong. Large profit opportunities present themselves when the market finally realizes it's wrong and corrects itself, leading to narrative transformations.

Oftentimes investors inject incorrect assumptions into a stock's price. Either they're expecting far too much growth in future earnings or far too little. The narrative based on whatever this earnings growth key driver is will only continue for so long. Eventually the investors realize their folly. A certain event or catalyst will trigger this realization and cause prices to readjust and trend in a new direction. Identifying **narratives, key drivers, and catalysts** is how we determine when and where these new micro trends will form.

The first step in this identification process is to understand the sales and earnings assumptions already embedded in a stock price. These assumptions tell us how the market views a company's future. We can then analyze how far off the mark (if at all) these assumptions are.

There's two ways to back out sales and earnings assumptions.

First there's the advanced option involving a reverse DCF (discounted cash flow analysis). We won't get into that method here. To be honest, we think it's overly complicated and doesn't add much value. But if you're interested in learning more about it, then check out Mauboussin's book *Expectations Investing*.

Next we have the easier approach of simply comparing multiples.

We can quickly identify the earnings expectations embedded in a stock's price by looking at its trailing twelve month price-to-sales (TTM) (P/S), price-to-earnings (P/E), and price-to-book (P/B) multiples.

High multiples mean high earnings growth expectations. And low multiples mean low expectations.

To discern what's "high" and "low", just look at past multiples at various times in the business cycle. Compare them to the multiples of other stocks in the same sector (different sectors and industries will be vastly different).

If the macro, price action, and theme call for further investigation into whether those multiples are warranted, we can begin digging into the stock's expectations to discern the validity of the narrative and also the potential catalyst for change.

"Financial markets, far from accurately reflecting all the available knowledge, always provide a distorted view of reality. This is the principle of fallibility. The degree of distortion may vary from time to time. Sometimes it's quite insignificant, at other times it is quite pronounced." ~ George Soros

You will need to become comfortable looking at financial statements; particularly income and cash flow.
Don't let the accounting lingo intimidate you. Financial statements are just business records. And every business, no matter how complex, has just five fundamental factors to its financials:

1. It sells widgets or offers them as a service (**revenue**).
2. Making and selling these widgets costs money (**total operating expenses**).
3. What's left over after these costs is the **free cash flow (FCF = operating cash flow - capital expenditures).**
4. Often businesses borrow money (take on **debt** or sell **shares**) to fund cash shortfalls or invest in future production. A company's level of debt compared to its assets determines the quality of its balance sheet.
5. This debt requires principal and interest payments. What's left after these payments is the company's **net-income**. Divide the net income by the amount of shares outstanding to get the **earnings per share**.

The supply of shares (float) is also important to pay attention to. A company with 2 billion shares outstanding takes far more demand to move its stock price than a company with only 40 million shares. A smaller float means a smaller supply, which can equate to a larger move (in either direction). With all else equal, a stock with a float under 100 million shares is preferable to one with a larger supply.

This is also why investors should be wary of companies that have a history of repeatedly issuing stock. Issuing shares is dilutive to shareholders. It hurts key ratios like EPS and P/E while adding supply to the market. It's generally best to stay away from companies that have issued a lot of shares. If they've done it in the past then they're likely to do it again.

Every business can be boiled down to these five fundamental factors and stock supply. Everything else in the financial statement is only important in how it affects one of the above.

The more comfortable you become parsing through financial statements, the more effective and efficient you'll be at identifying false narratives and spotting great trades.

Our team uses Ycharts.com for our fundamental analysis. We like it because we can visually chart fundamental data and easily compare past financials statements in a number of formats.

But you don't need to pay up for this software. You can find all the information you need directly from a company's statements and reports. These are not only hosted for free on the company's website, but also on other sites like Google Finance and Yahoo.

We generally go back at least eight quarters and look at trends in revenue, operating expense, free cash flow, debt/assets, and net-income (EPS). If a stock's narrative clearly changed near a certain quarter, then we want to look at specifically at that quarter's five key factors to see what happened.

Once we've spotted the key driver that changed on the income statement (i.e. an accelerating trend in revenues, decreasing profit margins due to new competition, etc.) we then want to go through the quarterly reports from the time of the narrative change to the present. We also want to skim through the quarterly calls to see if the narrative is still valid or if it's false.

You can find transcripts of every conference call at www.conferencecalltranscipts.org.

www.seclive.com is a good tool for looking at quarterly reports. It's much better than the SEC's site because you can highlight and make notes in the doc along with a number of other useful tools.

Potential catalysts that change the key driver could be:

- New management team
- New product
- Changing consumer trends

- Increasing/decreasing competition
- Changing cyclical environment

Maybe you find a beaten down stock with a low multiple that's suffering from a dead money narrative. But once you dig into the financials you see two quarters of improving revenue growth which include the first quarter of positive earnings in a year and a half.

You know from the reports and quarterly calls that new management was put into place last year. They've refocused the company on a more lucrative area of business.

You look at other companies in the new line of business and see they have high multiples in the 30's. You also think this last quarter of positive earnings is just the start of a new trend. And if you extrapolate this quarter's earnings over the next three, you get a P/E of just 8.

A P/E of 8 is cheap, but you believe it still grossly undervalues the company's potential because it doesn't factor in the new sales growth. Nor does it account for the fact that the company has operating leverage — most of its costs are fixed.

You factor in your conservative estimate for modest sales and earnings growth going forward. You adjust for the higher multiple it should receive for moving into the more exciting business space. And finally you come up with a *conservative* price target for your stock that is over 6 times its current price!

All you need now is a catalyst to set the stock's narrative transformation into motion. This catalyst will usually come in the form of a blowout quarter in sales and/or earnings where YoY numbers erase any doubt that the story has changed. Buyers rush in and the price doubles.

That's all there is to it!

Identify the market narrative and its key driver, investigate the credibility and future endurance of that narrative, model a potential earnings path forward, and wait for a catalyst to cause a narrative change.

Here's some additional numbers/factors you want to look into when investigating stocks:

- **Insider Buying:** A sudden spike in insider buying of a stock that has been beaten to a pulp and is trading at a low multiple is a signal to investigate. Conversely, if the stock is trading at highs and insiders can't seem to dump shares fast enough, it generally means there's not much value in the at those price levels. No matter how much we dig into a company, we'll never know half of what those on the inside know. Always pay attention to what the executives and board members are doing. And remember, it's the relative amount of shares they're buying/selling in comparison to their salaries. Insiders know the markets look at their share purchases and will sometimes purchase small amounts to signal confidence when there isn't any. A good site to look at insider buying is Openinsider.com. Finviz also has insider buying information at the bottom of each stock's page.

- **Comparables:** It's a lot easier for metrics like YoY sales and EPS to look great when they have a low bar to clear; meaning the prior four quarters were really weak and vice-versa if you're looking to short a stock. Always look at last year's quarter and compare it to what you believe will happen this quarter. This should give you an idea of how much runway your stock has.
- **Volume-to-float**: All things equal, a stock with a small float (number of shares publicly traded) is better than a stock with a large float. A good ratio to look at is float to average daily volume. The higher the volume relative to the float, the less activity needed to really move prices.
- **Operating Leverage:** We want to buy companies that'll see large increases in EPS for every dollar increase in revenue. This is known as high operating leverage. A company's operating leverage is determined by the amount of fixed and variable costs it has. Fixed costs are better because revenues can grow without any increase in costs. To determine the degree of operating leverage just divide the percent change in operating income (EBIT) by the percent change in sales.
- **Backlog:** Look for the word backlog when reading through quarterly reports. An increasing backlog usually equals higher earnings down the road. It signals the company's business is in good health.
- **Return on Equity (ROE):** The goal is to buy strong and efficient companies. ROE helps determine this. ROE = net income / shareholders' equity. Shareholders' equity is just the company's assets minus its liabilities. You want to buy stocks that can produce over 15% annual ROE.
- **Total Domination over Competition:** Peter Lynch liked stocks that he called "Blossoms in the Desert". These are good companies in bad industries. He preferred these over good companies in good industries because good industries attract a lot of competition. And competition is bad for profit margins. Yogi Berra once said about a popular restaurant, "it's so popular, nobody goes there anymore." The same applies to stocks. In bad industries, when things become difficult, most competitors fold and other businesses refuse to enter. Eventually these bad industries become good industries and the good company that was able to survive suddenly has the space all to himself. This leaves us with a well-run, low-cost producer with virtually no competition in an improving industry.
- **Avoid Self-Promoters:** We like companies where management doesn't toot their own horn. They're conservative in their forward guidance and have a history of under-promising and over-delivering. The same holds true for companies that constantly put out news releases with fancy slide deck presentations. This is a sign that management is focusing too much on the stock price and not on the company's core business.

➢ **Little to no coverage:** Generally the less a stock is covered by analysts and the less it's invested in by large funds, the more potential it has. This goes back to the importance of being a contrarian and investing in unloved industries. That's where the biggest mispricings occur.

There are really only three categories for stocks when looked at from a fundamental perspective. These are:

1. Growth (ie, earnings, sales, users etc.)
2. Cyclical (ie, commodity, real estate, consumer cyclical etc.)
3. Overreaction (ie, market mispricing of one time or short-term events/environments)

I'll be writing a future piece that goes into detail on how to specifically analyze each of these three types of fundamental plays.

Recommended Reading List for this section:
- O'neil's "How to Make Money in Stocks"
- Schilit's "Financial Shenanigans"
- Mihaljevic's "Manual of Ideas"
- Fearon's "Dead Companies Walking"

Conclusion

> *A chess student must initially become immersed in the fundamentals in order to have any potential to reach a high level of skill. He or she will learn the principles of endgame, middlegame, and opening play. Initially one or two critical themes will be considered at once, but over time the intuition learns to integrate more and more principles into a sense of flow. Eventually the foundation is so internalized that it is no longer consciously considered, but is lived. This process continuously cycles along as deeper layers of the art are soaked in.* **~ The Art of Learning**

Successful macro trading is a multi-layered game where the player needs to observe, synthesize, and act differently from the common market participant if he wants to win.

The Macro Ops approach to trade identification does just this. To recap:

❖ Survey the macro/liquidity regime to determine the secular/cyclical/intermediate trend
❖ Use both price action and themes to develop trading ideas
❖ Use technical analysis to identify potential consensus and inflection points
❖ Dig into fundamentals to determine market narratives

- Synthesize the information gathered from the above process to determine if the market narrative is false, what the catalyst is, and if price action offers a good R/R inflection point

This is the nuts and bolts overview of our trading process. This approach is successful because it allows you to identify trades that put *ALL* of the important factors in your favor, versus pigeonholing yourself into a single approach and choosing to remain blind to other important variables.

This report covered the basics of our approach in each section of analysis. We'll be covering each part in much greater detail in the future and will also be putting out a report on the far more important process of trade management.