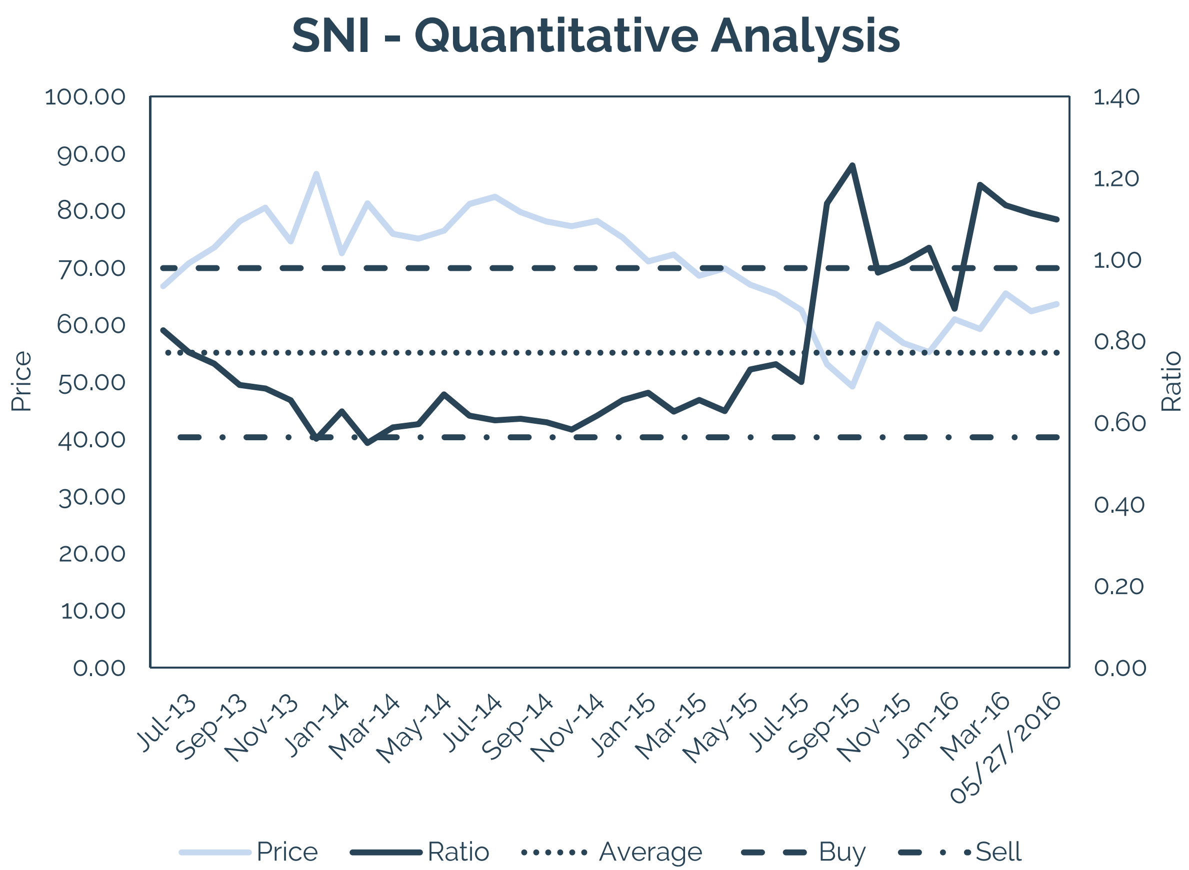
The Anatomy of a Buy

Over the past several months, one question we have received from many clients and other interested parties revolves around what it would take for our cash levels to decrease. To properly answer this question, our investment process and discipline need to be closely examined. It's not as simple as saying if the stock market goes down 5% we will all of sudden be fully invested. In addition, we don't stroll into the office everyday opining whether or not today is a good day to put cash to work. Our investment process ultimately makes the decisions. We let the numbers speak and check our emotions and biases at the door.

Everything we do starts with our multi-factor quantitative model. The beauty of quantitative analysis is there are no thoughts or preconceived notions. The numbers are what they are. Our universe consists of roughly 2,200 common stocks, which get an updated valuation ranking nearly every day. Without giving away the secret sauce, there are several inputs that go into calculating a proprietary ratio for each stock. This ratio is unique to each individual stock, which means each stock is evaluated based on its own merits and completely independent from the "stock market". As long as the ratio is positive for the entire time period being observed, the stock meets our quantitative criteria. If the ratio is negative or zero at any point, the stock does not fundamentally meet our standards. One way for a stock to have a negative ratio would be for the company to post negative earnings per share growth over any rolling 36 month time period. Every company will have a hiccup or slowdown from time to time. However, if a company cannot rebound quickly, they are typically too cyclical for us or have a structural problem with their business. Those stocks that do make it through our quantitative model end up getting a valuation ranking based on how the most recent ratio compares relative to its historical readings. And ultimately, we only truly care about those stocks that have significantly deviated in either direction from its historical average ratio. These stocks indicate an extreme under or overvaluation relative to their actual and expected growth prospects.

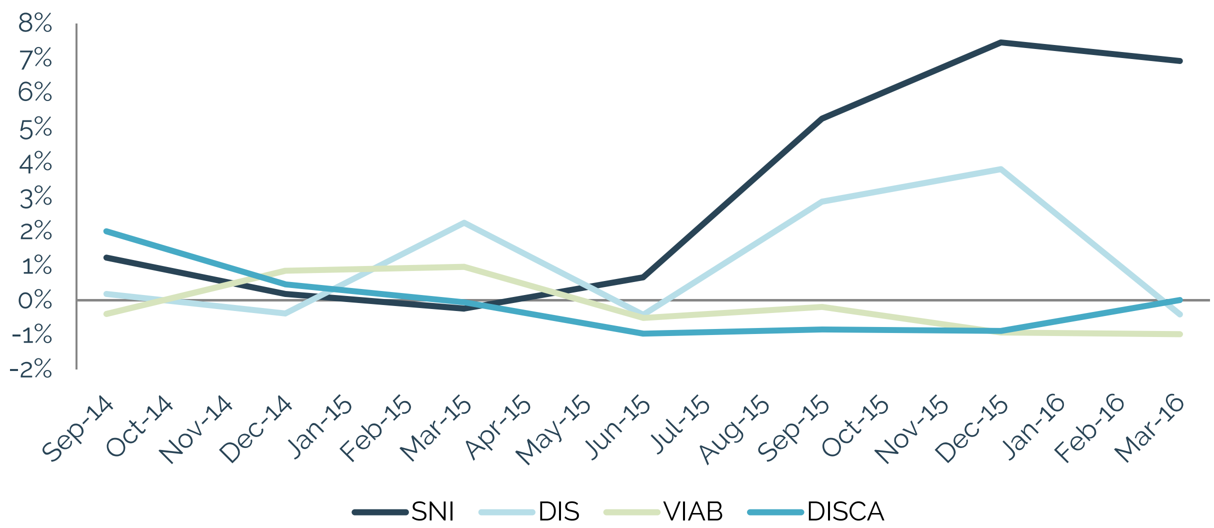
The chart below shows the ratio and stock price of Scripps Networks (SNI) over the past three years. In August 2015, SNI registered a "buy" signal when the dark blue line (Tandem's ratio) crossed over the highest dotted dark blue line. The ratio began to move up from hovering close to the "sell" line (lowest dotted dark blue line) throughout most of 2014 at the same time that the stock price (light blue line) began to move from the low \$80s to mid \$50s. Over the past nine months, the stock has remained attractively valued except for a brief moment in January of this year when the ratio dipped below the "buy" line.



Once a stock has been identified with a ratio that is statistically meaningfully higher than its average, it flashes a "buy" signal to us, as seen in the chart above. The next step would be for the stock to go through the fundamental analysis portion of the investment process. We use fundamental analysis for two reasons. First, it is used to evaluate the qualitative aspects of our most basic investment criteria. The most important being depth in management and consistently hiring from within. Second, it is used to validate the numbers that made up the valuation ranking from our quantitative model. We are not trying to play the part of a forensic accountant and pick apart every last number as to why we shouldn't invest in a particular stock. Instead, we are simply making sure the numbers are correct, sustainable and make sense.

In the case of SNI, the fundamentals of the company looked great. The company had grown revenues at a compounded annual growth rate (CAGR) of 7.86% over the past 5 years. Over this same time period earnings had grown at a CAGR of 15.63% and cash flow had grown at a CAGR of 10.82%. However, in the fall of 2015, the stock was trading as if their demise was right around the corner. At the time virtually all media stocks were taking it on the chin. Netflix was viewed as the death nail to anyone associated with cable. Apparently, everyone was going to "cut the cord" in the near future and traditional content consumption would go the way of the dinosaurs. Now don't get me wrong, I do believe the way we consume content will be much different in the future than it is consumed today. However, this doesn't happen overnight. In addition, if your content is good, consumers will demand it regardless of the medium used. SNI produces HGTV, Food Network, Travel Channel and DIY Network among several others. Who doesn't watch one of these channels? And if you don't, I can promise you someone in your house does. Where do you think the random conversations of installing a new backsplash in your kitchen come from? I digress a little, but it's all part of why we believed the fundamentals in SNI to be sustainable and mispriced at the time. SNI was getting lumped in with several of their flailing competitors and the numbers didn't paint this type of story for SNI. The chart below shows one of the most important metrics when analyzing a television network. Advertising revenue is the lifeblood of these companies. SNI stands head and shoulders above the competition and confirmed the ranking we got in our quantitative model.

Rolling Advertising Revenue Growth

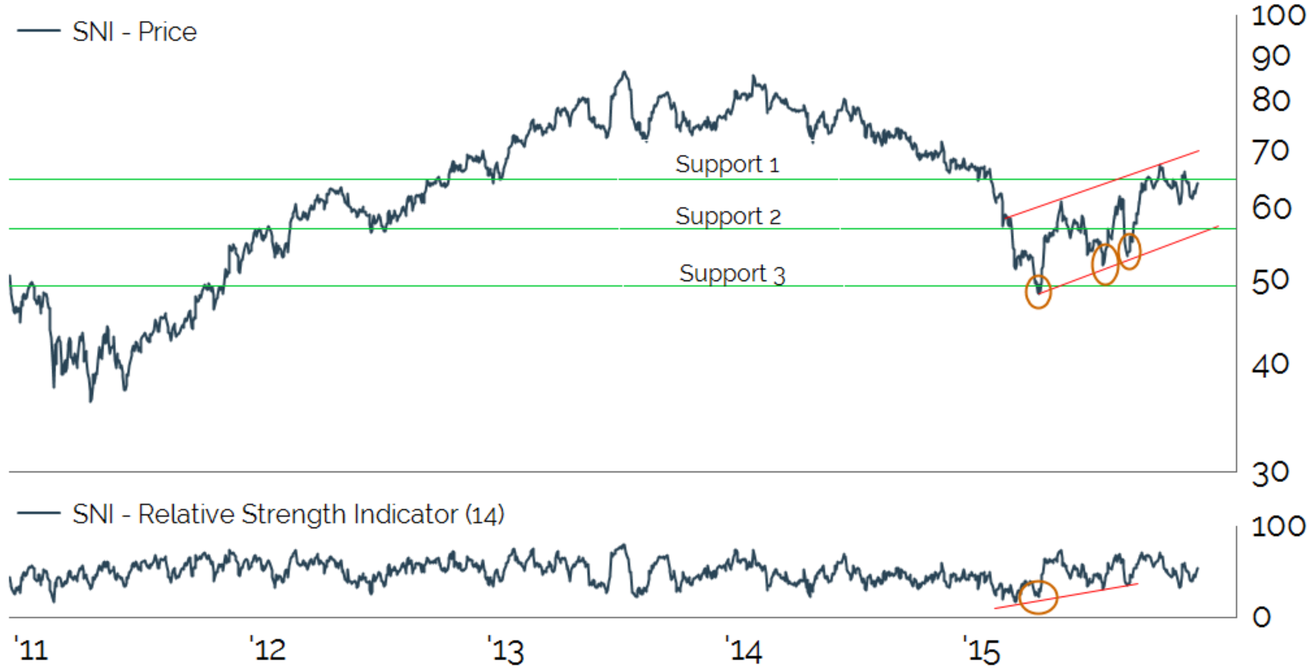


Source: SEC filings

After a stock with a "buy" ranking has passed through fundamental analysis portion of the process, the stock is ready to be bought in our clients' portfolios. However, the stock is not immediately bought at any price. Just as we were diligent in vetting the stock's numbers through quantitative and fundamental analysis, we are just as diligent in finding the right entry point for a new purchase. As I mentioned a few months back, we do not hold ourselves out to be master market technicians. Our strategy is not a "trading" strategy. It is a strategy built on owning companies with real, sustainable revenues, earnings and cash flow. The technical analysis we do is nothing more than making sure we are patient in buying a "falling knife" and more aggressive at getting a full position implemented once the stock has clearly bottomed. Sometimes it might take us the matter of a week to buy a stock up to our full position. And, other times it might take several months to buy the full position. It is all based on support, resistance, moving averages, trend lines and relative strength indicators. A stock might be extremely undervalued based on the quantitative and fundamental analysis. However, stocks can certainly get much cheaper if you aren't careful about what the price chart is telling you.

The five year chart below shows the bottoming process of SNI over the past nine months. The chart outlines the support (green) and trend lines (red) in both the price chart and relative strength indicator (immediately below the price chart). Each circle represents the most optimal time to buy SNI, as the price bounces off of support and/or the trend line. In addition, you will notice the relative strength indicator made a higher low at the same time the stock made a low and subsequently bounced off of the support 3 line. The fact that the relative strength indicator began to turn upwards before the stock made a low was proof that the stock was in the midst of a bottoming process. And, the probability was beginning to increase that the stock would soon reverse course to the upside. We took an initial position in September 2015 at a price that ranged from $51.84 to $52.70 and continued adding to our position over the next 5 months when the stock would dip back toward the mid $50s.

Scripps Networks Interactive, Inc. Class A



Source: Factset

So, you're probably wondering by now what we see today. Currently, our quantitative model assigns only 46 out of 2,200 stocks a buy ranking, which is 2.1% of our universe. Of those 46 stocks, we currently own 3 of them and are in the process of doing the fundamental research on 5 of the stocks. The remaining 38 stocks to get a buy ranking did not pass our fundamental analysis. Most of these stocks did not pass due to management not being hired from within, the fundamentals just didn't add up or their results were simply unsustainable. Since the start of this year, we have added to SNI and took initial positions in Intercontinental Exchange (ICE) and Bank of the Ozarks (OZRK). However, due to our quantitative model still showing more stocks to sell than to buy our clients' cash levels have increased slightly since the beginning of the year. I promise you this dynamic will change one day and we will be faced with more stocks to buy than to sell. At that time and only at that time will cash levels begin to decrease. If price was the only factor in our process then yes, it would be a lot easier to definitively tell someone when we might put cash to work. However, our process doesn't just analyze price, as it is only one factor in a multi-factor model. A decline in prices would be helpful, but we ultimately need to see revenue and earnings growth return before we get a flood of new "buy" signals.

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson