# 3M's method gives a comprehensive view of an investment

By Anet Ahern

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When picking a unit trust, a good place to start is by finding out more about the fund manager's investment philosophy, understanding it and ensuring that you can relate to their approach.

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There are many approaches in use today by various South African fund managers that have considerable merit. But when it comes to determining which companies' shares will grow your money over time, we believe that one of the best methods is looking at the 3M's - moat, management and margin of safety.

In essence, the 3M's looks for high-quality investments that are trading at discounts to their inherent intrinsic values. In this methodology, moat and management collectively represent a company's quality, while margin of safety represents its price. This is a concept investors can all relate to - quality at a good price.

## Moat

When looking at a company's potential as an investment, it's important to consider the future. While a company might be performing well and gaining market share in their industry, the measures in place and factors at play that protect their competitive edge must be considered.

A company with a reliable, effective product and a viable, sustainable market to sell to sounds like a great investment. But how easy or difficult would it be for a competitor to usurp the company's role in the marketplace? Does the company have enough of a handle on its industry to not fall by the wayside should someone else with the same products or new ideas come along? We look for companies which has demonstrated they have a competitive advantage in their fields and that this advantage is sustainable.

For instance, think of the cellular service providers. The government only issues a limited number of these licenses, making it impossible for new entrants to enter the market without this permission. Such companies (think of others who also have oligopolies like these, for example casinos) are hard to unseat due to licensing maintaining these moats.

Even so, price competition and ease of transfer are factors that weaken the lucky license holders' advantage; so one has to watch this advantage carefully over time as the industry and regulatory environment changes.

## Management team

The performance of a company, and by consequence the performance of your investment in that company, is fundamentally linked to the competence of its management team.

Management is the most nuanced of the three indicators employed to determine the value of an investment. When focussing on a company's management it is important to look at both the quantitative measures (like return on capital and dividends paid) as well as issues like the alignment of the incentives of the management team with the interests of shareholders, corporate governance structures and the like.

If you want to be rewarded as a shareholder, one thing to look for is a company managed by teams who are also significant shareholders in these businesses - where the management's rewards are strongly driven by shareholder returns.

Think of Naspers founder Koos Bekker whose primary form of remuneration when he was at the helm of the company was as a result of the performance of the share price and dividends paid.

Once you have determined that the company you want to invest in is above-average in quality, then the next inquiry is whether it is trading at a price which is unlikely to cause you a capital loss over your investment horizon.

## Margin of safety

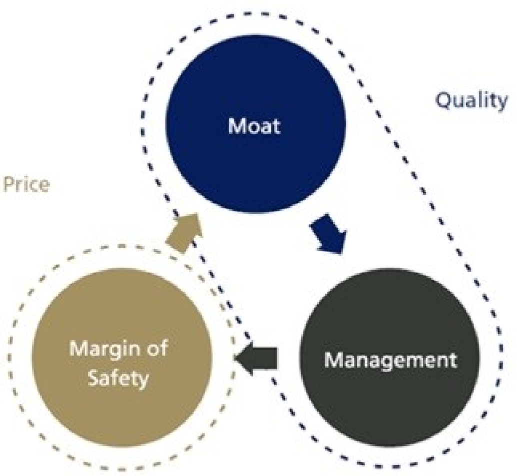
When you look at a company's moat and management, it is essentially an examination of the quality of the company. An investor should be looking to only invest in quality companies and if the opportunity is of an inferior quality then it does not matter what its valuation is.

Margin of safety is the difference between a company's prevailing market value (via its share price) and what its intrinsic or fair value is. Once the share price moves to a degree where it does not compensate you for the risk that one inevitably takes when buying a share, it is time to sell. Just because you are looking to invest in a fantastic company it does not mean that you should do so at any price.

At the end of the 1990s, during what has now become known as the 'dot-com bubble', the share prices of even some of the best quality tech companies - companies which have survived and thrived after the collapse of many of their peers - fell significantly and took a significant period to time to recover because they were too expensive to start with.

The 3M's method allows an investor to take a simple yet comprehensive view of an investment. It allows the investor to see the bigger picture, while taking the necessary relevant details into consideration and ultimately to grow their investments over time.

Figure 1: The three Ms of the PSG investment philosophy - the PSGAM equity process




Source: PSG Asset Management

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