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Investors cast a wide net to fish for stocks

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People often ask why we rarely share stock ideas in our column. In our experience, people misuse such information more often than not because they act without fully considering each investment's role in their financial strategy.

Everyone's goals, risk tolerance and time frames are different. Instead of learning to fish, some people ask (and sometimes pay) others to throw fish at them. It is a good way to get smacked in the face, end up with a foul-smelling pile of carcasses, and learn nothing about where, when and how to catch fish.

Many professional investors reap great rewards by investing in obscure companies, causing some investors to wonder where to find "hidden gems." Those willing to do a little legwork learn that many of these gems are hidden in plain sight.

While it's true that one can discover investment opportunities by noting businesses with long lines or a lengthy backlog of orders, professional investors need a more systematic and reliable process for maintaining a pipeline of possibilities. Here are five tools we use as our market "radar."

Public filings

One of our co-workers is a huge film buff who is a fan of Wall Street Journal film critic Joe Morgenstern. "Not only is Morgenstern a great writer," says our associate, "but over the years I've come to trust that his tastes are similar to my own. I know that if he loves or hates a film, there's a high probability I will also."

Similarly, we monitor the "13F" filings of like-minded investors — those who have proven to share our entrepreneurial approach. "13F" refers to an SEC rule requiring quarterly disclosure of the investment holdings of those who manage more than $100 million in equities. It has proven to be a great source of new investment ideas.

Another public filing is the 13D, a required disclosure for activist investors who own more than 5 percent of a company. 13Ds can alert one to special situations that might present special investment opportunities. Yahoo Finance and the Edgar Web site are good resources for this sort of information.

Industry periodicals

A large supermarket magazine rack might appear to have a slick periodical for every imaginable consumer interest, but believe us — they barely scratch the surface of what's out in the business world. We continuously review publications focused on drug delivery technology, confections, supermarkets, alternative energy, oil and natural gas, healthcare, home healthcare, restaurants, apparel, and beverages. New periodicals are added to the list regularly, as we seek to expand our circle of competence.

Industry publications are helpful because they not only keep us informed about trends affecting the industry, but they also alert us to companies operating on the periphery, providing tools or services to the main players.

The people who provided picks and shovels during the California gold rush became much richer than the miners, so it pays to keep an eye on business opportunities adjacent to the main industry.

Traditional media

Publications such as Value Investor Insight, The Wall Street Journal and Barron's are essential resources, providing social, political and financial context, as well as specific investment ideas. These publications also provide insights into herd mentality; one should not follow the herd, but should be aware of such movements to keep from getting trampled.

We sometimes find intriguing competitors to companies profiled in the mainstream media. For example, someone operating in the same market space but with better capital allocation skills.

We also attend industry and investment conferences, which are as valuable for networking as for the information. Networks mutually benefit the attendees, sponsors and presenters. Our own address at the 2007 Value Investing Congress West introduced us to many like-minded investors.

Data-driven stock screens

One of our proprietary screening processes compares a company's stock price to its net tangible assets (e.g., cash, real estate and working capital) and cash flow. We slice and dice the numbers, churning the data to bring ideas to the surface. We also use our computer stock screens to search for significant insider net purchases and stock buybacks, both of which helps us understand management commitment and direction.

While professional investment managers tend to purchase very powerful and customizable screening products, many online services offer easy-to-use screening tools to help investors identify companies that might interest them. Fidelity.com, for instance, allows clients to design their own stock screens or use templates designed by professional money managers. Yahoo Finance also offers a useful search and screening capability.

One of our analysts hastens to point out that we run these screens constantly and they often go nowhere. But really, that's the idea: The whole point of a "screen" is to weed out ideas that don't fit our strategy.

Eyes and ears

We believe it is important to know what we know, know what we don't know, and know who knows the things that we don't know.

One can expand or reinforce one's circle of competence through interaction with trusted experts. All of our business associates and clients have their areas of expertise, and we turn to them for ideas.

It also pays to consider the products and services we see and use in our own lives. One of our colleagues switched his company to new customer relationship management software a few years ago. It turned out to be so superior to his previous system that he invested in the company.

Too many ideas?

With more than 10,000 public companies, one could easily be overwhelmed by opportunities, so it is important to start with a well defined investment strategy. For example, although we do not discriminate based on so-called "style boxes" or market caps, we do maintain very specific criteria for stocks on our watch list.

Once a company shows up on our radar, we quickly evaluate its business model, competitive advantage, recurring revenue, inventory risk, internal alignment of interests, culture, organizational structure, reinvention risk, capital requirements, and demographics. Few companies make the cut, so we don't mind starting with a large number of ideas.

At the outset, we alluded to an old adage: "If you give a man a fish, he eats for one day, but if you teach a man to fish, he eats for the rest of his life."

One could hike all day along a river wondering where to fish. But knowing what fish you want, where it might be, what it likes to eat and what gear will be adequate is knowledge that leads to self-sufficiency.

Likewise, good investing ideas can truly be found anywhere, but the best ideas come through focused, methodical and consistent search techniques.

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