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WATCHLIST THE GLOBE AND MAIL

Add ‘owner earnings’ to your toolbox of financial metrics

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SPECIAL TO THE GLOBE AND MAIL

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Much ink has been spilled on the best financial metrics to use when looking for stocks. Some investors focus on the price-to-earnings multiple, the dividend yield or the price-to-book value. Each metric provides some insight but leaves me wanting. Instead, I ask whether a business possesses a sustainable competitive advantage; I then try to calculate the intrinsic value of the business.

Understanding the sustainability of a company's business advantage is the first step and vitally important. Most companies don't have a permanent edge and so their financial results tend to be erratic and unattractive. A few years of strong profits attract competition which drives profits back to unattractive levels.

However, a few businesses possess a special quality – a "moat" – that allows them to earn high profits year after year. Moats come in many forms: valuable patents, strong brands and sheer size are some examples.

To find these special businesses, I look for companies that have historically earned high returns on equity and returns on invested capital over many years. Like a homing device, these two numbers will guide you to the places where you should be focusing your attention.

Once I find an attractive company I try to figure out the intrinsic value of the business. Simply stated, this is the amount of cash that you can take out of it over its useful lifetime. To get a handle on that figure, I evaluate the "owner earnings" of the business, a concept that was introduced by Warren Buffett in 1986.

Mr. Buffett defined owner earnings as reported earnings plus depreciation, amortization and certain other non-cash charges, less average annual capital expenditures that the business requires to maintain its long-term competitive position.

Calculating owner earnings requires hard work and numerous value judgments. It is not an exact science but will produce results that matter. Using net income, P/E ratios or management's adjusted earnings figures are quicker, but usually less insightful.

There are exceptions, though. I recently read the annual report for a small company based in Calgary called Pulse Seismic. The company's management touted their preferred financial metric – shareholder free cash flow. This metric ignores certain amortization expenses that accounting rules require them to deduct and other one-time items. However, I believe that management's way of looking at the business is the right one, because shareholder free cash flow is a good proxy for the owner earnings of the business.

I did not buy Pulse Seismic primarily due to its valuation, but management's discussion of how they think about their business left me impressed. They are focusing on what truly matters.

Discovering a business with a sustainable competitive advantage and then determining its historical owner earnings allows you to value it. The sustainability of the company's moat allows you to predict its future results with reasonable certainty.

The final step is making sure that the price you pay for the stock is sufficiently below its intrinsic value that you are purchasing with a large margin of safety.

You are sure to make a few mistakes in your analysis when trying to accurately predict the future. Buying cheap allows you to do so yet still earn attractive returns in your portfolio over the long run.

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