Never Forget Rule Number One

TAMRO Capital Partners' Tasho learned how to invest during a bleak time in market history.

Famed investor Warren Buffett is often cited as having two general rules of investing, "Rule number one: Never lose money. Rule number two: Never forget rule number one." That lesson is not lost on Philip Tasho, co-founder of TAMRO Capital Partners and manager of the Aston/TAMRO Small Cap and Aston/TAMRO All Cap funds. Frequently, a portfolio manager's investment philosophy is shaped by a defining moment or series of events during their formative years in the business. Such is the case for Tasho, who learned firsthand how difficult the market can be as he started his career amid a particularly grueling period in the history of US stocks.

Tasho began as an analyst—a generalist who covered stocks across a variety of sectors—in a bank trust department in 1980. Coming off a sideways market during most of the 1970s, the mandate from cautious clients was simple: "Don't lose money." Unfortunately, things only became worse during the years that followed. Adverse political events, sky-high interest rates to combat rampaging inflation, and the end of a bull market in energy made investing during the subsequent 18 months sheer terror leading up to the 1982 recession. It was an experience that Tasho would not soon forget, one that indelibly formed his philosophy of risk awareness and the importance of trying to minimize losses by owning quality companies.

Best-in-Class

From that experience, Tasho decided to study the characteristics of stocks that worked. The idea was to find a common thread that would help distinguish the winners from the losers going forward. It didn't take him long to recognize the importance of valuation as a key metric, especially in seeking to control risk. Amid the market environment at the beginning of his career—one absent a strong upward trend—the timing of buys and sells was crucial to squeezing out returns and avoiding major downdrafts. Still, valuation in and of itself is more of a tool—a trigger, for entering and exiting positions at the appropriate time—than a stand-alone strategy or process. After all, some stocks are cheap for a reason, and the cheap stock of a lousy business has the potential to get even cheaper. Thus, Tasho decided that in addition to valuation he also needed a way to pinpoint those firms that he thinks are "best-in-class."

Many firms can succeed when times are good, but as Tasho learned during the early 1980s, few are able to survive and thrive during tough economic periods. Today, he and his team of analysts conduct in-depth fundamental research to find such companies. They look for firms with proven competitive advantages or those that dominate a particular market niche—and are thus able to keep potential competitors at bay. While TAMRO looks for a solid record of historical results for perspective, Tasho also focuses on future earnings using forward-looking metrics to assess the sustainability of the underlying business. Any such analysis naturally includes a thorough vetting of financial statements, liquidity—since access to credit markets is never a given, especially for smaller companies—and whether a firm is currently experiencing peak or trough margins. The latter measure is especially important in determining the proper context for targeting the valuation of a company going forward.

Another key characteristic for Tasho is the need for strong company management. TAMRO evaluates not just the top person, but the entire team—and the culture it fosters. He believes that it is during the lean periods that management really earns its pay. Thus, he looks for repeatable patterns of behavior on the part of management that enhances shareholder value, even amid industry and market rough spots. Tasho prefers long-tenured management or new teams (not just a new chief executive officer) with a clear history of success elsewhere.

Leaders, Laggards, and Innovators

The common thread, as Tasho discovered, is in finding stocks that combine all three traits—well-run firms with significant competitive advantages that also happen to be cheap. In practice, however, stocks that fit the profile aren't especially easy to find. Gradually, Tasho learned to root out opportunities by seeking such stocks when they were temporarily out-of-favor or when he thought the valuation based on historical patterns offered a three-to-one ratio of upside potential to downside risk. He would then sort potential candidates into three distinct buckets that ultimately became known as Leaders, Laggards, and Innovators.

The truly dominant, smartly run companies—or Leaders—have qualities largely recognized by the market such that their stocks typically trade at fair value or a premium, leaving little margin for error. But even these companies are susceptible to short-term setbacks or negative sentiment that can temporarily depress the price of the stock. It is then that Tasho becomes an interested buyer and, not surprisingly, stocks in this category tend to make up a majority of the assets in the Aston/TAMRO funds. Laggards are generally firms Tasho believes have a solid core business but that have underperformed owing to operational problems and/or poor management. They're already cheap and simply need a catalyst—in the form of operational changes, a restructuring, or reinvigorated or new management—to unlock value. Finally, Innovators are companies that Tasho sees as new growth opportunities and future industry leaders, the potential of which he thinks isn't fully reflected in the stock price. Since the assessment of these companies is still based largely on promise, however, innovators typically represent 10% or less of assets in a portfolio.

TAMRO will also use industry research and quantitative screens to focus their fundamental research effort to a manageable number of firms. The quantitative model serves as an idea generator that ranks all of the companies in the universe by decile, with the top three deciles serving as potential buys and the bottom three as sell candidates. The industry research is also largely quantitative, based on 13 historical factors including past returns, which provides a big picture backdrop for the individual company fundamental analysis and input into which bucket a particular stock belongs.

Protect and Participate

At the heart of TAMRO's process is a cautious approach developed by Tasho from his experience as an investor, one shaped by valuation and the purchase of high-quality businesses as a means to control risk. Granted, this strategy can appear volatile relative to peers and passive indexes from time to time. Tasho runs relatively concentrated portfolios and pays little attention to the sector weightings of the benchmark. In fact, sector weightings in the Aston/TAMRO funds can vary widely depending on where Tasho is currently finding values in the market. The focused portfolios reflect his desire to own what he believes are the best companies and the difficulty of finding well-run, truly dominant firms at an attractive price.

Still, while the goal is to help protect investors during rough stretches while fully participating in market rallies, Tasho is less concerned with short-term swings than delivering strong absolute returns over the long haul. His aim is to assess a firm's ability to maintain its competitive advantages going forward, during both good times and bad. The key to long-term success for such an approach is to fully know and understand the companies in the portfolio so as not to panic on disappointing short-term news, and instead buy more. More importantly, having suffered through one of the worst periods in the market at the beginning of his career, Tasho has developed the fortitude to be such an investor.

Article written by:
Kerry O'Boyle is an Investment Strategist with Aston Asset Management. Prior to joining Aston he wrote on a variety of investment topics as a Mutual Fund Analyst for Morningstar, Inc. Kerry is a graduate of the U.S. Naval Academy, and holds an M.A. in Liberal Arts from St. John's College, Annapolis, MD.

Note: Small- and Mid-cap stocks are considered riskier than large-cap stocks due to greater potential volatility and less liquidity.