Stephen Clapham – Behind the Balance Sheet

Stephen Clapham is the founder of Behind the Balance Sheet, a training and research consultancy, which he set up after he retired from the hedge fund world. His book, the Smart Money Method, How to Invest like a Hedge Fund Pro, was published in November 2020. The book is a shortened version of his online school course, Analyst Academy – a 12-month program to give private and professional investors the skills to understand financial statements, pick stocks, construct, and manage an investment portfolio. https://www.behindthebalancesheet.com/

1. **Investingbythebooks:** You are the founder of Behind the Balance Sheet and an accountant. You have a great chapter in the book about this, so everyone should read that to get the details. But to get everyone more interested in balance sheets questions, do you have some simple advice/ideas for the investor what to look at?

   Stephen Clapham: Top 3 things to look for, i.e., warnings signals; compare with peer group margins, the free cash flow generation, and its working capital ratios.

   On the balance sheet, you can learn a lot from studying the balance sheet line by line – whether it's the goodwill note revealing details about an acquisitive company's M&A Record or the Tesla customer deposits line revealing that the company collects sales in advance of delivery. The balance sheet is always revealing!

2. **IBTB:** I think you make an excellent point on the potential of better planning (personally, I am guilty of spending too much time on Trump, macro and the P&L, but I have managed to avoid Zero Hedge). Could you please elaborate a bit on this subject?

   SC: When I worked as a management consultant, I spent one day a week planning. When I started at a stockbroker no one knew what to do, they all reacted on news. I think everyone should spend time to think about where you make the most money for the time spent. The problem in research is that you do not know how long it will take, how complicated it is, but you should always try to estimate. That enables you to prioritize and make more money.

3. **IBTB:** Gross margin has become a key focus over recent years, and especially the incremental gross margin. You rise a red flag if the valuation is more than 12x EV/Sales, but many analysts, to motivate the high valuation for growth companies, assumes very high drop-through. If you consider that, could/should a valuation be higher than 12x?

   SC: Gross margin might color it a bit, but key is EBIT margin. In the book I wrote that I avoid valuations of >12x. But it depends on the size of business. If it is a billion-dollar business, and the valuation is more than 12x I have a problem, since very few stocks is then viable investments. Exception being high EBIT margin and very high sales growth, say 30%+ and 40%+ EBIT margin for several years. But that is not common, especially outside tech.

   I put Amazon on my buy list in 2014. Then it was obvious that gross margin was inflecting (by then we did not know it was the impact of AWS) and EV/Sales was just 2x two years out, which was in line with the market. Margins had been flat-lining before, but this was the key trigger for the buy recommendation.

4. **IBTB:** Reviewing positions is an underestimated art, which you address. You mention the need for a review if stock is -20% from the purchase price.

   SC: -20% happens all the time. Nothings fundamental needs to have changed, since I look for inflection points 6 months to 2 years ahead which the market might not look for. Then you are in danger losing money until Mr. Market see what you see. I would be more cautious if a stock makes relative sector lows and if the leverage is high.

5. **IBTB:** Changes over time in book value per share. I am old enough to remember when that mattered, like yourself. But if you try and give your view why it is still relevant for the future?

   SC: The growth in book value tells you about the increase in shareholder value delivered through earnings and other value accretion not necessarily through the P&L. Book value growth can be affected by buybacks etc. but I tend to look at what a company has done over the last several years in terms of revenue growth, how much of its revenue has been captured in margins and how much of that profit has been retained and how much has been turned into cash – it's a good snapshot of a company's development. This is true whatever the industry, but with tech companies in particular, additional work is required to look at metrics like customer acquisition cost and the customer lifetime value. The book was intended for private investors so I did not go into too much detail on this, but we have a course dedicated to this subject for institutional investors and we may publish that in the online school in due course

6. **IBTB:** You have a big focus on the importance of having an out-of-consensus view on EPS. What is the easiest way to have an out of consensus view of it?

   SC: It´s not one thing, in general it´s changes in external environment that hasn't been priced in. Can be commodity prices/FX, or expectations, which enables a different cost base or sales level. Those changes can be very powerful.

7. **IBTB:** Technical analysis. Clearly you have learned from a few masters, for instance Crossley/Glydon. What are the key things you always make sure to look at? If everything is wrong with the chart, but your fundamental work says it fantastic, do you wait for the technicals to change, or do you good ahead, nonetheless?

   SC: I would wait to buy it. But if you are big, then you must buy regardless. I also look for volume confirmation, that is very important.

8. **IBTB:** Stephen, some final words please?

   SC: Investing is difficult, but not too difficult, everyone can do it. The book provides a method and process and will help with more good decisions and fewer bad.

Bo Börtemark, January 22, 2021,
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