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During The Zurich Project 2017 I introduced the idea of Intelligent Cloning. It's all about combining the Ben Graham thinking on risk aversion with the Charlie Munger rule nr. 1 on how to become a successful investor: carefully look at what other great investors have done. You can find the initial write-up on intelligent cloning here.

I introduced five criteria to avoid the too risky stocks and then rank the remaining investment ideas according to a Joel Greenblatt type of ranking system. In this autumn edition on intelligent cloning I elaborate a little bit more on this "Joel Greenblatt type of ranking system" and what I mean by that. And then we will have a look at the autumn 2017 results. Enjoy!

Ranking the stocks

If you use the original Joel Greenblatt ranking system, you rank e.g. 10 candidates by ROC. The highest gets 1 point and the lowest 10 points. And then you rank them by margin of safety. The highest gets 1 point and the lowest 10. You add the numbers and choose the lowest number.

If you have two companies with identical ROC and company A grows e.g. with 3% free cash flow per share and company B with a 6%, both companies are treated equally. I tend to believe that there is value in adding additional weight to company B.

The question is how to do that. During the Zürich Project 2017 I introduced the Value Creation Engine. The more aggressive definition of this Value Creation Engine is ROC times GROWTH. A more conservative approach is to add just a few extra points to the ROC for company B. In the latter case you could argue that the Value Creation Engine is a sort of adjusted ROC. This might seem a simple idea, but in reality it is not. There are many ways to calculate ROC and GROWTH. You have to decide for yourself what suits you best.

The same holds for the third variable, Margin of Safety. Joel Greenblatt used the Earnings Yield, which is EBIT/Enterprise Value, but there are many other ways of calculating the Margin of Safety and once again, it depends on your personal preferences.

The Autumn 2017 results

If I apply the conservative approach of the Value Creation Engine (VCE) with the preferences I have for Margin of Safety and then rank the stocks, first according to VCE (the highest VCE gets 1 point, the lowest 10 points) and then according to Margin of Safety (the highest gets 1 point, the lowest 10 points), add the two numbers (the lowest number comes first) and do just that for the portfolios of Berkshire Hathaway, Sequoia Fund, Chuck Akre, David Einhorn and Allan Mecham, I end up with the following results:

1. Apple (Berkshire Hathaway ↑, David Einhorn ↓)
2. Verisign (Berkshire Hathaway)

3. IBM (Berkshire Hathaway ↓)
4. Delta Air Lines (Berkshire Hathaway ↓)
5. Emcor Group (Sequoia Fund)
6. Omnicom Group (Sequoia Fund ↑)
7. PVH Corp (David Einhorn ↓)
8. Liberty SiriusXM Group (Berkshire Hathaway ↑)
9. Jacobs Engineering Group (Sequoia Fund)
10. Davita (Berkshire Hathaway)

The arrows indicate if there has been some recent activity in buying/increase the position ↑ or selling/decrease the position ↓. No arrow means no specific recent action.

Obviously, there are some limitations to this approach. Most of the financial companies and spinoffs are automatically excluded. And you might want to ask yourself the question if it is wise to “clone” the Berkshire Hathaway portfolio. Berkshire Hathaway has a limited investment universe, because of its size. They only look for “the big elephants”. It might be much more interesting to look for companies that are at the beginning of their competitive lifecycle (small and midcap stocks).

If I exclude the companies with a market cap above 5 billion USD I end up with the following ranking:

1. Emcor Group (Sequoia Fund)
2. Tegna (David Einhorn ↑)
3. DSW (David Einhorn ↑)
4. Dillard’s (David Einhorn ↑)
5. MSC Industrial (Allan Mecham ↑)
6. USG Corp (Berkshire Hathaway)
7. Boston Beer Company (Allan Mecham ↑)
8. AutoNation (Allan Mecham ↑)
9. Monro (Chuck Akre ↑, Allan Mecham ↑)
10. Valmont Industries (Allan Mecham ↓)

By the way, if I move the benchmark for VCE just a little bit higher, and I might do that next time, Valmont Industries would not be on this list.

Some final remarks. You could argue that intelligent cloning is a new quant approach, a sort of algorithmic overlay on top of all the intensive research and decision making of these super investors. But there is no such thing as an investment without your own investment analysis. I always reengineer the investment thesis and do my own due diligence and I advise you to do the same.

The greatest advocate of “cloning” in the investment world is obviously Mohnish Pabrai. He introduced “shameless cloning” in an article in Forbes entitled “Beyond Buffett: How to Build Wealth Copying 9 Other Value Stock Pickers”. So is “intelligent cloning” more intelligent than “shameless cloning”? I don’t think so. It’s just a matter of words. “Shameless cloning” is highly intelligent and “intelligent cloning” is just as shameless.

Intelligent cloning is a more risk averse, conservative approach towards cloning.

Next time, the winter 2017/2018 edition on intelligent cloning, I will include the portfolios of David Tepper and Seth Klarman. Should be quite interesting!

I am always happy to answer your questions or discuss what needs to be discussed: peter@thevaluefirm.com.