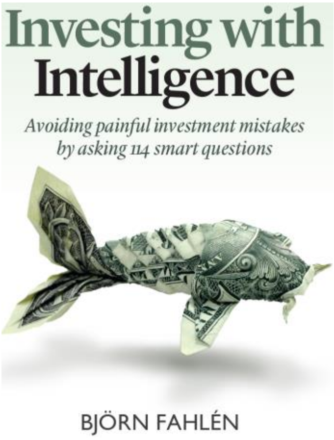
Author interview:
Björn Fahlen, "Investing With Intelligence"



Björn Fahlén has spent over 25 years in the investing world as investor, analyst and financial advisor. He is the refounder principal shareholder and CEO of Redeye AB, a Stockholm-based boutique investment bank that specialises in innovative growth companies and was founded in 1999. He also leads Redeye's research product and is Chief Investment Officer (CIO) of its fund advisory business.

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InvestingByTheBooks: Björn – it is truly a special moment for us to be interviewing and interacting with a fellow Swede, and to talk about your upcoming book! It is called "Investing With Intelligence – Avoiding painful investing mistakes by asking 114 smart questions". Quite a title! Give us some background on your journey leading up to this book

Björn Fahlén: This book began as a small internal project at Redeye. The project's initial scope was to institutionalise lessons learned from refining the equity research process during my many years as an equity analyst and investor. I would say that the process started about 10 years ago. But initially it was just an internal document for our analysts. It was actually, the chairman of MOI Global and managing editor of The Manual of Ideas, John Mihaljevic, who inspired me to publish my writings about the subject in a book format. That was about three years ago, after I contacted him for feedback on the checklist. However, writing this book has been a way of thinking more clearly and building deeper understanding – not just a way to teach equity analysts.

InvestingByTheBooks: There is the wonderful quote "There are old pilots, and there are bold pilots, but there are no old, bold pilots" in the book. I guess the same can be said of investors in general and about you specifically. Early in the book you cover your own missteps in the biotech-bubble in the late 1990s, and that tale is so reminiscent of many other investors. Do you think it is almost a pre-requisite to fail early on?

BF: If you learn from your- and others' failures early on, when you don't have much money at stake, it is easier to come back into the game again. However, I don't think it is a pre-requisite to fail early on but learning from your mistakes and those of others certainly is. Trying is the best way to move forward, and failure is the road to success. Fail early and fast and you will find success much faster, but only if you admit and learn from your failures. In my case I almost lost it all early on and I learned some hard truths on the way. I think it was critical for my mindset at that time, but it's certainly not a recipe for everyone!

This also has to be put into context of my early experience. I was bitten by the investment bug when I was about 15 years old. My first two investments were Pharmacia and Astra. Investing started to dominate my conversations with my friends when I was about 20 years old. And in my early 20s I studied chemical engineering, economics and business administration at a university. I then moved on to a biochemistry Ph.D. program, partly because of my family history of cancer. The biotech sector became my circle of competence until I was about 30 years old, from there it expanded into medtech, diagnostics and life science tools as I started my career as an equity analyst.

InvestingByTheBooks: So how did your investment approach look during those formative years?
BF: My first phase was spent as a biotech speculator, where I typically invested heavily ahead of data release or drug approval. After some missteps in the biotech-bubble in 2000 I almost lost it all. Then I developed a strategy for biotech-investing. The strategy was to take the initial stake off the table right before the tombola stopped spinning in order to just risk the gains. Typically, in these special situations, expectations get higher as we get closer to the event and we see a surge in price – hence there were typically gains to risk. This was a fairly successful strategy to me, but when combined with leverage and an extremely concentrated portfolio of three to five stocks it became a deadly cocktail during the financial crisis 2008. This was the second time I experienced that I had put my finance at risk. However, this was a turning point of my life as an investor as I began to look for quality growth stocks instead of hope-stocks. I call these stocks *emerging compounders* in my book.

Experience comes with age. However, it would be nice if people could start investing at a young age and not make any mistakes along the way. But the truth is that sometimes you just have to make these mistakes – to develop an investment strategy that is resilient and works for you. Think about it, most first-time investors start out as casual investors. But we also know that investing in the stock market requires discipline, patience and a proper strategy. The latter takes time and experience to develop.

InvestingByTheBooks: Tell us about the investors that have inspired you! And perhaps when in your career.
BF: While we all have different paths to getting acquainted with the stock market, reading a wide range of authors can save years of painful lessons. One of the books that truly opened my eyes, made me take notes frenetically and empowered my investing strategy was *One Up On Wall Street* by Peter Lynch. This book taught me how to process a growth opportunity and to build my own investment strategy.

Another investor that had a huge influence on me early on was Philip Fisher who was preaching the idea of focusing on great businesses that are fast-growing with a large untapped potential rather than focusing on bargains. His book *Common Stocks and Uncommon Profits* was a lightbulb-moment to me. Some of the nuggets in the book that have served me well are:

- Hold for the long term.

- Look for great investments.

- Favour businesses that allocate their assets towards what will be most beneficial for their long-term growth – which rarely is a dividend payment.

I also have to mention Howard Marks as reading his book *The Most Important Thing* opened my eyes to the importance of a contrarian mindset and insights on understanding market cycles. But, to be fair, there isn't much in this book that you won't find already in other classics by Graham, Klarman, Taleb, Montier or Mauboussin. But the writing style of Howard Marks and his simple way of explaining powerful concepts can have a lasting effect. I typically never miss a memo of his at Oaktree Capital.

Yet another book I also have to mention is *100 Baggers* by Chris Mayer who studied the characteristics of companies that have returned 100-fold for its owners. The book opened my eyes to the necessary ingredient to owning an outstanding winner in your portfolio. The idea is to invest in companies that have the potential to vastly outpace others and stick with them as long as the thesis is intact – holding on to let the power of compounding do the work.

In short, to see compounding returns work in your favour, time is the most essential ingredient. The simple idea of trying to own 100-baggers changed the way I invest as it compels me to invest in superior businesses and give me the fortitude to hold onto them, even when a company reaches a lofty valuation. However, the idea that patience is the most essential investor quality is not new and preached by Warren Buffett himself when he says, "Inactivity bordering on sloth is the cornerstone of our investment approach."

InvestingByTheBooks: The gist of your book is the "114 smart questions" – i.e. a detailed scuttlebutt checklist. Have you read other books in the genre? Which ones stand out to you?
BF: There are not many books that are explicit about checklists and that was probably one of the reasons why John Mihaljevic told me that my writings about the subject would do good as a book. However, I really enjoyed *The Investment Checklist* by Michael Shearn and as I said before, *Common Stocks and Uncommon Profits* by Philip Fisher. Both these books helped me understand how to get a more thorough understanding of the business and its people. For example, I was unable to assess management quality very well before I read Fishers book, and that proved to be part of my investment's downfall earlier in my carrier.

InvestingByTheBooks: Which other books – and please choose at liberty - have inspired you?
BF: Except for the books mentioned before there are many more that have slowly shifted my mental models and the way I invest. But I believe these books changed my life as an investor for the better.

Yet, books from authors focused on behavioural investing, in particular those from Montier, O'Shaughnessy, Greenblatt and Crosby.

When it comes to decision making and probability, I think of Taleb, Duke and Portnoy.

When thinking about business in general I would say Thiel and Moazed,

Finally, when it comes to biographies, I must mention Spier, Schroeder and Baid as their books preaches a holistic approach to investing – to compound knowledge, goodwill and relationships instead of merely compounding money.

All these authors would have been worthy additions to this list

InvestingByTheBooks: How come you have written the book in English, as opposed to Swedish? Whom would be the symbol of the target audience you are aiming to reach?
BF: As I said before this project started out as an internal project at Redeye. All our processes are in English, so I really never considered writing the book in Swedish. But I think I would have written it in English anyway.

The answer to the second question, about the target audience, I would say Redeye's equity analysts and other independent thinkers who commit to undertaking the deepest bottom-up fundamental research on companies. Those who stick to what they know, know what they own, and think about it more consciously.

However, a second group of readers for this book is senior managers and directors who are willing to roll up their sleeves and get into the details of how great companies create long-term shareholder wealth.

*InvestingByTheBooks: If we get into the Checklist, and more specifically your "**Questions to ask before investing"**. As always, there is a sort of tug-of-war between "ample evidence" and "catching them early enough". How have you handled this delicate topic?*
BF: The best way to catch them early on is right before they turn cash flow neutral in two to three quarters and then cross over to free cash flow territory. That is when you get the most operating leverage, the best risk-reward. Moreover, its key that the company have good prospects for an extended period of high growth and an extraordinary management.

Fishing in the sleepy backwaters of the larger caps is a proven investment strategy. It is often the case that many smaller businesses trying to make a breakthrough will invest more to secure larger future profits at the expense of current profits. These companies will often have stocks that are undervalued and perfectly positioned to see a huge surge in growth, sales, and overall profits in the near future.

InvestingByTheBooks: 114 questions – why 114?
BF: It happened to be 114 as I have six sub-questions to each main question, and there are 19 main questions. The idea is that one indirectly answers the main questions by the more powerful sub-questions as they refine your thoughts and help you refine your inquiry. For the more experienced investor, the 19 main questions will probably do the job – and only using the sub-questions when unsure about the main question. That is how I do it.

InvestingByTheBooks: So how do you actually use it, in your daily work-flow?
BF: Typically, I run the checklist as "the last thing", before making an investment, to verify that nothing is missed. Usually it takes no more than 30 minutes to run it. It will highlight the issues that you should go back and do some more research on. This is actually exactly like Guy Spier and Mohnish Pabrai use their checklists.

However, you can also use the checklist as a starting point for the entire research process from which to gain a deeper understanding of the business and its people. Something that makes the fundamental analysis more consistent and less time consuming.

InvestingByTheBooks: And, indeed – some of your questions go back ten years and look for clues into a company´s future, whereas plenty are more "here and now". How do you balance this?
BF: There is no clear way, or right way, of doing this. The checklist has been built over my years as an investor and a businessman by learning from my own and others' mistakes. It's a rather based

on a gut feeling based on those experiences. For some questions there is a clear explanation to why a longer or shorter view is better.

For example, the growth rate analysis is more focused on the near-term growth trend as research shows that the historical long-term growth rate is not very predictive of future stock returns. Growth tends to naturally slow down as a company gains size over time. What is more important than the growth rate is the durability of the growth, something covered by the competitive analysis.

*InvestingByTheBooks: We really enjoyed the "**Investor Communication**" part of the book, and how sincerity and dedication in a company really have the ability to shine through in those few rare cases. But it is a complex part of financial analysis due to its inherent subjectivity. What are your sources of inspiration in this field?*
BF: Most of it is based on my own experience, but there is one book that inspired me more directly when it comes to communication – *Investing between the lines* by Rittenhouse. Other sources of inspiration are blogs and articles. I read a lot, but struggle with remembering author names as I am totally focused on ideas. My bandwidth simply doesn't allow me that!

InvestingByTheBooks: Another very topical issue these days, sure to only increase in loudness and impact, is the discussion around index funds and its close peers. The exact number varies depending on how you measure it, but we would be in the right ballpark if we say that around 40% of the ownership and 80% of a normal day´s trading is controlled by passive funds. If we leave the price-discovery mechanism of markets as a result of these numbers out of this interview, and instead focus on the governance- and stewardship aspect of companies – what are your thoughts here?
BF: Fundamentally, financial markets exist to intelligently allocate capital to where it will create most value over time. Without a value judgement on the part of the decision-making investor it can create a new sort of market bubble. I guess there is a bubble in ESG investing right now. Also, I guess passive ownership have increased volatility in the markets as their fund flows en masse. Therefore, the impact blurs the distinctions between different companies.

Moreover, I believe passive managers are more inclined to vote in favour of the management proposals. I guess there are studies that shown that executive compensation structure and corporate strategies have become more complacent when passive ownership is more abundant.

I know this topic is hot, but to me it doesn't change how I pick stocks as I rather focus on the company quality. What are your thoughts about the subject and how does it change your way of investing?

InvestingByTheBooks: Well, as Larry Cunningham (author of several great investment books, nonetheleast Essays of Warren Buffett, said: "You get the shareholders you deserve". So, reversing that, we are putting even more emphasis than before on family businesses, owner-operated businesses and other cases where shareholders who are non-business minded, just price-minded, occupy the majority of the register. One also has to accept as a new normal the increased volatility in share prices. An annual volatility of 40-50% (i.e.. between high-low in a year) is just the ordinary state of affairs. Use it to your advantage!

InvestingByTheBooks: Getting back to the book: have you adapted the questions a long-term fundamental investor should ask as a result of 40% of ownership being in the hands of passive mutual funds? "Someone else´s money". As opposed to how it looked 30 years ago, when the "good" answers to ownership questions might have been different?
BF: You certainly have a point when it comes to having a controlling owner or a group of shareholders acting together. But I guess the passive ownership from index funds is more pronounced in larger companies and less relevant for the small cap space where I hunt, so it may explain why I haven't thought about it. Perhaps I will think over it until I publish the book, it's just one or two questions that might need to be calibrated. Thanks for asking.

However, when it comes to insider ownership it's more a question if they own enough to care, a meaningful ownership stake. It's not so much about how big the stake is in percentage points of the total outstanding shares.

InvestingByTheBooks: Your day-time job is not as an author, but rather running an investment boutique in Sweden called Redeye. Tell us how that have interlinked with this book! We guess it has been a two-way street there as far as inspiration goes?
BF: I would say that I am in the business of acquiring wisdom. As a businessman you need to understand the same ideas and concepts of what makes a company great as you do as an investor. They are very much interlinked.

Redeye to me is a way of being actively engaged of the business in which I have invested most of my money and time. But it is also a platform for research and investing, by providing capital and bringing together investors and companies that may all benefit from a win- win situation – not just me.

When it comes to the craft of writing, I don't actually like it very much. To me writing is rather a necessary learning process and perhaps more than anything else an expression of my passion for investing.

InvestingByTheBooks: What are your hopes and ambitions for the book?
BF: Hopefully this book will help investors developing a deep understanding of a company's qualitative dynamics and future potential. It doesn't matter whether you copy the checklist or customize it to your needs, as long as it improves your qualitative analysis of the company.

Following a checklist that focus on the qualitative aspects will lead to minimum use of detailed financial models and the habit of focusing on big picture numbers and deep simplicity. Most importantly, developing a deep understanding of each investment help you to manage risk through knowledge. The latter is critical for any investor in order to become successful over the longer term.

InvestingByTheBooks: This has certainly been a pleasure. We enjoyed it very much and hope our readers will walk away from this discussion a little wiser. And of course, eager to purchase the book! When does it hit the virtual bookstores?

BF: I am hoping for early summer so in time for everyone´s vacation reading!

BJÖRN FAHLÉN IN ~~10~~ **60 SECONDS**

Annual reports or corporate biographies?
I find more than 9 out of 10 annual reports worthless. Biographies on the other hand tend to shed some light on timeless lessons from the corporate world. Nonetheless, I read more annual reports than corporate biographies.

Buffett as a Genius or Buffett as an Intelligent Fanatic?

Vanguard or KKR?
None, but if I have to choose to put my own money at stake without knowing who is managing the money, I would choose Vanguard any day. Most stock pickers fail to generate performance that justifies their higher fees. Also, I urge anyone to look for high manager ownership and be

sceptical to the more sales-driven than performance-driven approach that most mutual funds pursue. There's a lot more money in selling than in actually managing funds today. Vanguard and KKR are two examples of that.

Redeye or full-time author?

Market crash in 2021 or not?
My short answer is that I have no idea, you can't predict it. But what you think is much less important than how you think.

I am not the only one to see a number of early warning signs that the party is about to end. However, one never knows, by analogy, which snowflake will trigger the avalanche. All you can know is that an avalanche is likely. Still, it is easy to be early, and being too early may lose you your credibility or sometimes even your job.

When I look at the growth, valuations and liquidity in the market – there is a mixed picture today. We see good growth induced by increased productivity driven by new technologies and extreme liquidity that fuels the market exuberance we see in today's valuations, which is on record high levels. I really feel like it's never been more difficult for investors.

This leads me think about the so called "greater fool theory" were buyers don't worry about whether a stock is priced too high because they are sure someone else will be willing to pay them more for it. But, a strategy dependent upon outfoxing the next guy is typically a formula for failure over the long run.

Then I consider the abundance of financial liquidity that has already added fuel to industrial commodity and real estate price inflation. And when we see inflation, stock prices typically go up. Yet, forthcoming fiscal stimulus is likely to put upward pressure on bond yields. We have already seen the long-term interest rates go up, but the party isn't over until the liquidity in the stock markets evaporates. But no one can tell when that will happen. Particularly as governments will attempt to limit or reverse any climb. So that's the long answer to your straightforward question.

I still find some great opportunities in today's market even if they aren't abundant. However, when I scan my portfolio, each position must spell out quality. Also, I always prefer to have some dry powder to act whenever an investment opportunity appears. But, holding too much cash for fear of a market crash will almost certainly cause one to miss extended periods when markets perform well. Hence, placing a large weight on avoiding a market crash is simply too dangerous.

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