Insights from Morningstar

Lesson 301: The Fat-Pitch Strategy

"All I can tell them is pick a good one and sock it."—Babe Ruth

In baseball, a batter who watches three pitches go past just inside the strike zone will be called out by the umpire. Also, as many baseball fans know, the strike zone from one umpire to the next can be a different size. Baseball players thus often have an incentive to swing at pitches they would rather not, out of fear of being called out.

Many investors, especially professional money managers, think about investing like it's a baseball game. Because they aim to beat the indexes they are being scored against, professional money managers feel a lot of pressure to get base hits, doubles, triples, and home runs in order to earn their keep. Out of fear of being "called out," they might swing at pitches that may be just inside the strike zone, even though they may prefer to watch those pitches go by. In other words, investors often forget their valuation discipline and think about investing like it's a baseball game—three called strikes and you're out. So they swing away.

But what if the rules of baseball were different? What if a batter could watch any number of pitches go by, waiting for the perfect "fat pitch" to come along before swinging? Baseball will never adopt this rule, of course—games would last too long and pitchers would bemoan their escalating ERAs. But as an investor, you can (and should) play by these rules.

You can significantly raise your investment batting average by waiting for the pitcher—Mr. Market—to throw you a nice fat pitch right down the middle of the strike zone. Unless the market throws a pitch that you're very confident in swinging at, you can stand by and watch strike after strike be thrown without worrying about being called out, because, unlike in baseball, there is no penalty for being patient in investing. With the market pitching, you can let as many curveballs, knuckleballs, and sliders go by as you like until you see the one you want to hit.

The fat-pitch strategy that we have developed here at Morningstar has five parts:

1. Look for Wide-Moat Companies.

As we've described in the previous workbooks, companies with wide economic moats reside in profitable industries and have long-term structural advantages versus competitors. These companies are fat pitches with predictable earnings, returns on capital higher than the cost of capital, and long-term staying power.

The beauty of a wide-moat company is that the odds are pretty high that the actual intrinsic value of the firm will increase over time, leading to higher shareholder value. In other words, time is on your side with these companies. By contrast, companies with no economic moat generally destroy shareholder value over time—when you buy a no-moat company, you're making a speculative bet that the stock will bounce up just long enough for you to sell it. That's a very tough game to play, and generally only seasoned pros should attempt it.

Keeping a Wide-Moat Watch List

We recommend maintaining a watch list of wide-moat companies that you consistently monitor for any opportunities. You can also input and manage your watch list using Morningstar.com's Portfolio Manager. Premium subscribers can also use Morningstar.com as a resource to see which companies we think have wide moats.

Once you've compiled a list of wide-moat stocks, you can set up alerts that will inform you when certain events occur, such as when a stock's price drops below the price at which you'd consider buying it.

2. Always Have a Margin of Safety.

Instead of buying a stock based on what everyone else is doing, buy a stock only when it's selling at a decent margin of safety to your estimate of its fair value. Don't even think about the overall direction of the stock market because that's impossible to predict with any consistency. By doing this, you'll need to exercise a lot of discipline and wrestle with the fear of missing out on a market rally. Patience is indeed a virtue when using this approach because oftentimes it may take many months, or longer, before a fat-pitch opportunity presents itself.

Although you may feel at times that the market is running away from you, and a fat pitch may never come around, rest assured that there will be opportunities in the future, and you'll be poised to swing away. Think only about individual wide-moat companies; if you find one where the price is irrationally low relative to its long-term intrinsic value, consider buying it. If not, hold off for a fatter pitch.

Obviously, to determine whether a particular stock is trading with a sufficient margin of safety, you must have some sort of an estimate of what you think the stock is worth. These workbooks have given you enough information that you should start to be able to place a value on a stock. We encourage you to practice this repeatedly to hone your valuation skills.

Also, you must determine how much of a margin of safety you'll require before buying a stock. If the firm is not very risky, you could be content with a 15%-20% discount to its fair value. If the firm is riskier than average, you may demand a 30%-40% discount. Ultimately, it's your decision.

The beauty of fat-pitch investing is that it has two built-in factors which help offset the risk that your fair value estimate is wrong. First, by requiring a margin of safety, you've given yourself some "error cushion," just in case your estimate was too high. Second, by purchasing wide-moat companies, chances are high that the firm will increase in value over time. Thus, even if your estimates were way off, the firm—and its stock price—will likely appreciate in value, eventually catching up to your fair value estimate. In effect, by buying wide-moat companies, you have another margin of safety built into your investment.

3. Don't Be Afraid to Hold Cash.

Holding cash is like holding an option—the option to take advantage of volatility in the market. The value of this option rises when market volatility rises. Thus, when the volatile stock market provides you an opportunity to buy wide-moat companies at bargain prices, you'll be ready with cash in hand to take advantage of the irrationality.

Many market participants often neglect this important aspect of investing and stay fully invested at all times. For instance, many professionals getting paid to invest other people's money feel they are actually required to stay fully invested even if there's a lack of fat-pitch opportunities. Thus, when the market drops, they often can't do anything but watch (or worse, sell out near the bottom).

Being fully invested at all times goes hand-in-hand with the professional's focus on relative returns—beating an index. For example, if the market drops by 10% in a year, but the fictional Relative Return Fund dropped only by 8%, Relative Return's manager has provided value because the fund had a better return relative to the market. However, had you invested in this fund, you'd still be 8% poorer, not exactly anything to cheer about.

We argue that individual investors should care more about absolute returns (how much money did you make) and less about relative returns (did you beat a benchmark). So if the market isn't throwing you fat pitches, just hold on to your cash and wait until it does, because fat-pitch investments are much more likely to provide strong absolute returns over time.

4. Don't Be Afraid to Hold Relatively Few Stocks.

There are very few good ideas in any given year—Warren Buffett has said he's happy to have even one. For the rest of us (i.e., those without the need to invest several billion dollars to make a difference in their portfolios), there may be five or six good ideas a year. In any event, if you feel the need to hold more than 20 stocks, you probably aren't using the fat-pitch approach—more than likely you're speculating and trying to diversify away the risks of your speculations by holding lots of different names. Remember, it takes great patience to be a fat-pitch investor, but when opportunities present themselves (nice fat pitches right down the middle), you should buy boldly (swing away).

We caution you, however, that it's risky to hold a concentrated portfolio (few positions) unless you do three things:

1. Buy only wide-moat companies, which will increase in intrinsic value over time.
2. Buy them only at a significant discount to fair value (a margin of safety).
3. Have a time horizon of at least three years on each pick you make. It may take this long (or longer) for the market to recognize the value of a company.

If you aren't willing to follow these three rules on each and every stock you buy, then you probably need more diversification in your portfolio. (We'll talk much more about portfolio construction in Lesson 310.)

5. Don't Trade Very Often.

If you're using the fat-pitch approach, you won't need to trade very often because you'll hold only wide-moat companies. By definition, a wide-moat company has long-term advantages and creates shareholder value year-in and year-out. Because a wide-moat firm creates value each year, its fair value tends to increase over time. These are the only types of stocks in which a buy-and-hold strategy works well because the odds are in your favor that the actual underlying value will continue increasing over time. As we mentioned earlier, when you buy a company with no moat, you are making a bet that it will bounce up just long enough for you to sell it.

Think of it this way: Investing is nothing more than a game of probabilities. No matter how diligent you are, your fair value estimate for a stock will never be exactly right. It's really just an estimate of what a stock is worth under the most likely scenario for future earnings growth and profitability. Thus, there's always less than a 100% probability that you'll be right about a stock pick. Given that the odds are below 100%, there's little point in trading from one stock to another frequently; your odds of being "right" on the new pick are probably only a little higher than the odds of being wrong on the current pick.

Add to this the costs of trading—including taxes, bid-ask spreads, and commissions—and the odds of generating higher returns by trading frequently are worse than simply buying great stocks at good prices and holding them for three years or more.

The Bottom Line

By following the fat-pitch approach to stock investing, we think you can tremendously improve your odds of investment success. Although it requires plenty of discipline and patience, you should be able to earn strong returns over the long term by buying only those stocks that present a nice fat-pitch opportunity.

Investor's Checklist

- The fat-pitch strategy is based on a baseball analogy. Instead of watching borderline pitches go by, batters often swing away because they fear being called out on strikes. Similarly, many investors—instead of waiting for fantastic investment opportunities (fat pitches)—choose to buy stocks that they may not be too enthusiastic about, out of fear of being left behind by the market.
- There are no called strikes in investing.
- Individual investors often have an edge over professionals because individuals are not required to be fully invested at all times. Thus, they can patiently wait for fat pitches to come along without being worried about being called out.
- The five steps of the fat-pitch approach to stock investing are:

  1. Look for wide-moat companies.
  2. Always have a margin of safety.
  3. Don't be afraid to hold cash.
  4. Don't be afraid to hold relatively few stocks.
  5. Don't trade very often.

Quiz

Answers to this quiz can be found on page 175

1 Which of the following is not one of the five steps of the fat-pitch approach?

a	Have a margin of safety.
b	Maintain a very diversified portfolio.
c	Don’t trade very often.

2 Is it a detriment to fat-pitch investors to hold cash when the market is rising?

a	Yes.
b	No.
c	Maybe so.

3 A wide-moat company is typically characterized as having:

a	Long-term structural advantages over its competition.
b	Returns on capital lower than its cost of capital.
c	A perpetually cheap stock price.

4 Which of the following is not a reason that investors should refrain from trading often?

a	Costs of trading—taxes, commissions, and bid-ask spreads—can add up.
b	Once a stock is purchased, it should never be sold.
c	The odds of being “right” on a new pick aren’t much higher than the odds of being “right” on your current fat-pitch holdings.

5 The fat-pitch approach to stock investing is best described as?

a	Buying average companies at below-average prices.
b	Buying above-average companies at below-average prices.
c	Buying above-average companies at average prices.

Worksheet

1 In your own words, how would you characterize the fat-pitch approach to stock investing?

2 To help you remember, list the five steps of the fat-pitch approach:

1.

2.

3.

4.

5.

3 Explain why individual investors actually have some advantages over professional money managers:

Answers to this worksheet can be found on page 183