The Luster Matrix

Collaborative Investing

Achieving Higher Returns Through Shared Knowledge

Collaborative Investing is an investment research philosophy that I have followed for 11 years. It has proven its worth time and time again. Essentially, it is uniting the knowledge base of industry experts – practitioners in specific industries with a working knowledge of products – with your financial expertise.

To solidify this concept, the industry expert needs to be a co-investor, to align their interests with the firm's. This allows for the development of more in-depth research, which leads to better-informed investment decisions and a more thorough product understanding, which reduces risk.

There are many aspects of research with respect to investing that must be understood and evaluated in order to make informed decisions. Two of the most important are product knowledge and balance sheet analysis. One should know what the products do, how they are manufactured or developed, what they are used for, and who buys them. Ultimately, the only way to really understand how a product works is to use the product. It is deeply important for a professional investor to understand each product's "value proposition." This is largely impossible unless an expert in each area provides true user information.

Regarding the financial analysis, some questions to ask are: Is the balance sheet strong enough to build the business model management describes? Does this company have enough liquidity to survive? To succeed? How does management allocate company resources (return on investment)? How capital intensive is the business? Collaborative Investing provides a way for investment advisors to extend their understanding of products from the users' or purchasers' viewpoint. This is much more objective than relying on briefings with corporate executives. How would you ensure that the information that you are getting from your industry expert is accurate and objective? If the expert's assets are invested alongside yours, chances are they will work hard to be as accurate and timely as possible with the information they provide. Many firms hire consultants who are experts in their respective fields; however, because the consultant does not have any risk involved (with the exception of their paycheck) it is easier to postulate information under pressure, which can lead to misguided investment decisions. In addition, for Collaborative Investing to truly fulfill its potential, all expert viewpoints that you cultivate must be balanced. More than one expert in every industry sector must exist, and from more than one region.

For example, if you have a cardiologist from California who says, "All the cardiologists that I know are using X scalpel," they may only know doctors from the West Coast, while there may be a greater number of doctors from New England that may be using another brand of scalpel. Had you invested in the company that manufactures product X, you may have made a costly decision.

The components that make this type of investment philosophy work are as follows: first, you must find the experts; second, you must get them to invest with you; third, you need them to believe in the model; fourth, you must conduct regular meetings; fifth, and most important of all, you must create a relationship based on two-way communication between your firm and your investment partners. Building the network of experts and making them investors takes time; however, if applied appropriately, the benefits can be rewarding. Utilizing this philosophy, The Abernathy Group has been able to surpass normal investment results, garnering financial gains of five to 10 times greater than the general marketplace over time, and with less risk.

Also, the relationship between the firm and the investor truly becomes a partnership where the interests of all investment partners are aligned. At the end of the day, the client enjoys the investment process because they become a part of it and because they understand that Collaborative Investing costs them nothing while allowing them the freedom to contribute to the process.

Steven Abernathy is the founder and a principal of The Abernathy Group, and currently manages over $150 million, applying three core strategies — deep fundamental research, focused diversification and concentration in high growth industries. He may be
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INSIGHTS

Don't Go With the Flow

Luster Matrix goes beyond the DCF for True Valuation

One of the most popular valuation methods on Wall Street is the discounted cash flow model (DCF); however, The Abernathy Group has found a way to improve upon the model so that valuations are more accurate. The assumption behind the DCF model is that a business is worth the present value of its future profits or cash flows.

The difference between the DCF valuation and the current stock price will determine whether or not a stock is over or undervalued. The Abernathy Group believes that the DCF model is more often than not inaccurate because it requires the investor to accomplish impossible tasks including predicting 10 years of financial performance and placing a terminal value on a business 10 years from today. Thus, their team set out to devise a more accurate and functional valuation model, and developed the Luster Matrix.

To address this issue, they went back to the drawing board with some top analysts and money managers to devise a solution. In mathematical equations, if the numbers put into the formula are incorrect, then the calculation's outcome is incorrect – "garbage in, garbage out." The Group's approach is to increase the accuracy of the cash flow predictions by only estimating cash flow for the next two years. Also, the terminal value of the business can be more accurately devised within a two-year time frame, for discounting both of those values back into today's value.

The Luster Matrix attempts to price a firm (within a fair range) using only three variables: expected earnings over only two years into the future; the expected P/E multiple two years into the future; and a discount rate (which fairly estimates the risk of error in your predictions over the next two years). As P/E ratios are fairly constant within an industry (at least in the short run), and expected EPS can be estimated more accurately over a shorter time frame, the Luster Matrix gives a fairer assessment of the range of probable market pricings on a selected security.

The purpose of the Luster Matrix is to address weaknesses in the DCF model by shortening and simplifying estimation periods. The Abernathy Group notes that its goal is to make proper valuations of companies in order to make the right investment decisions for its investment partners, and the Luster Matrix is a valuation method that the firm believes will help achieve this result.

For more information on the Luster Matrix, see The Abernathy Group's website, www.abbygroup.com. The firm may be contacted for a working model of this tool at info@abbygroup.com, or at 212-293-3456.

ISSUES WITH DCF

• Difficulty in accurately estimating earnings or cash flow generated by a target company each year for the next 10 years.
• Impossible to estimate earnings and cash flow over the next 10 years in technology and healthcare.
• Impossibility of placing a terminal value on a business 10 years from now. What will its cash flow be?
• What are the company's capital demands in year 10? What is the interest rate environment 10 years from now? (About as hard as predicting the weather 10 years from now.)
• Impossible to capture an accurate firm specific discount rate (WACC) as firm risk is dynamic due to changes in capital structure and risks associated with the undertaking of new product investments.

ADVANTAGES OF LUSTER MATRIX

• Shortens the forecasting period from the life of the firm to two years.
• Provides a range of potential prices, allowing for some variation of expected P/E ratios and short-term discount rates.
• Setting the discount rate at the minimum return expected for the investor to make an investment. Allows users to determine what price the security must reach to meet a required rate of return.
• Eliminates the need to estimate long-term interest rates.
• Disregards future changes in firm structure, financing, and specific capital expenditure and investment decisions by shortening the estimation of cash flow horizon.

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