INDIVIDUAL PORTFOLIO MANAGEMENT

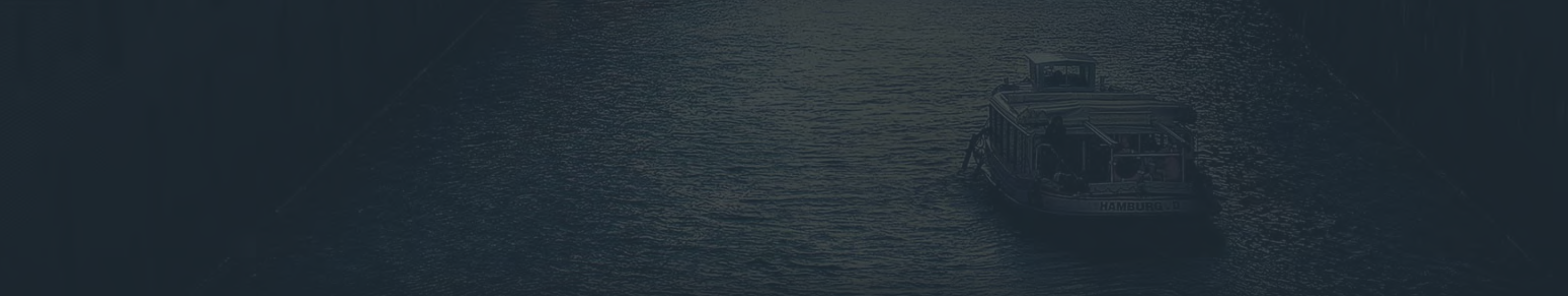
IMA

SINCE 1979

WE GROW YOUR WEALTH.

YOU DON'T WORRY ABOUT THE MARKETS.

We custom-build a stress-tested portfolio designed to navigate you through bad patches in the economy and markets, so you can enjoy the good ones.



This brochure is also available in audio format.

You can download it by clicking below:

IMA at a Glance

WHY IMA?

WE CREATE A SEPARATE, CUSTOMIZED PORTFOLIO FOR EACH CLIENT, WHICH MEANS:

- **Your assets stay with you**

  We don't custody your assets. They remain in a discount brokerage under your name; we simply have a limited power of attorney to enter buy and sell orders. We cannot disburse funds.

- **You won't pay for others' success**

  Since each portfolio is different, we don't have to invest your money in stocks that are no longer undervalued just because other clients bought them at a better price. And since the account is in your name, you own your own cost basis; you won't pay taxes on other clients' gains.

- **Your ethical & tax concerns are accommodated**

  It's your portfolio and we can custom-tailor it to avoid industries that go against your ethical principles, such as defense or tobacco. We can also make sure you make capital gains or losses for tax purposes. Just let us know what you need.

WE'VE CREATED IMA TO BE A FIRM WE'D WANT TO BE CLIENTS OF, WHICH IS WHY:

- **We eat our own cooking**

  Our CEO Vitaliy Katsenelson's entire family investments are handled by IMA, including those of his three kids and his relatives. That's because we firmly believe that IMA's methodology is the only sane way of investing in today's economy. We have no conflicts of interest – we've built this company so that our interests align entirely with yours.

- **We don't do dumb things with your money...**

  ... like buying a stock because our competitors bought it or because we need to make this quarter's numbers look good, despite its being bad for your portfolio long-term. We invest in businesses we think are good for your portfolio. Period.

- **We'll explain exactly what's going on in your portfolio**

  Four times a year, you'll receive a detailed letter describing the rationale behind each decision we've made in your portfolio. (You can read a sample of such a letter here). If you have any questions, the decision-makers are just a phone call away. We won't make you jump through hoops to talk to a portfolio manager.

ASSETS UNDER ADVISEMENT:

$500M

SEC REGISTERED INVESTMENT ADVISOR

OBJECTIVES:

Minimize risk of loss of capital (even in the worst markets), maximize long-term returns

METHOD:

Long-term-oriented active value investing

PERFORMANCE INFORMATION

✓ Available on request

MINIMUM INVESTMENT:

$500,000

FEES: 1.0 - 1.5%
(negotiable beyond $6M)

ASSETS CUSTODIED IN YOUR NAME WITH:

Fidelity Investments

charles SCHWAB

Dear Potential Client,

We aspired to build an investment service that we would love being clients of, and we are proud of the result. The document in front of you will give you an in-depth look at IMA, our values, our client experience, and our investment process.

Keep in mind, we designed this brochure for those who love to read. If you want a shorter summary, head on over to our website at imausa.com.

Is IMA for you? What we offer may not be for everyone, but we are the firm if you are looking for:

- Low-risk value investing oriented towards long-term growth
- Research-based, fad-free stock selection
- Full transparency about what your portfolio contains and why
- Custom-tailored portfolio and client experience
- Direct line of communication with decision makers
- No conflicts of interest
- Managers who own the same stocks as you

We tried to answer any questions you might have, but if there is something left unanswered, we'd love for you to get in touch. Just call us at 303-796-8333 or email us at contact@imausa.com and we'll get back to you within one business day.

Sincerely,

Michael Conn, CFA, Chairman Emeritus & Founder
Vitaliy Katsenelson, CFA, CEO

IMA

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Our Core Values

1. Total Transparency

Unlike other firms, we'll explain exactly what's in your portfolio and why it's there. We pour our heart into our quarterly letters so that you see the reasoning behind any purchase, sale, or hold in your portfolio. You can also see each position and cost basis on the custodian's website (reported daily). Still have questions? We can answer them by phone or email.

2. Our managers own the same stocks

Virtually all Vitaliy's and Michael's liquid assets are managed by the firm, invested in the same stocks as the rest of our clients. That includes Vitaliy's personal account, as well as those of his wife and three kids. So stocks that are bought or sold in your accounts are automatically bought or sold for Vitaliy's son, Jonah; his daughters, Hannah and Mia Sarah; his wife, Rachel; and Vitaliy himself.

That's because we firmly believe that IMA's methodology is the only sane way of investing in today's economy. Why would you ever invest with people who don't do the same?

3. No second-rate investments

If we can't find a high-quality company (in the US or internationally) that fulfills our rigorous valuation criteria and is incredibly cheap, we will simply hold more cash.

4. No chasing fads

We protect your portfolio by sticking to rational research-based decisions. With clear, strict guidelines for the kinds of businesses we'll invest in and specific sell criteria, we won't buy or sell simply because everyone else is buying or selling – unless our research concludes that it's good for your portfolio.

5. Tailored Approach for Each Client

Just because we bought a security a year ago doesn't mean it's a good purchase for you right now. We don't railroad new clients into stocks we currently own, unless we still think they're a good deal for you. And since you own your own cost basis, you won't be paying taxes on gains enjoyed by previous investors.

Have other concerns? We can skip purchases of stocks you don't want to buy, such as defense or tobacco. We can also make sure you make capital gains or losses for tax purposes. Just let us know what you need.

6. Just a Phone Call Away

Any questions, comments, or concerns about your portfolio? We won't make you wade through an automated phone system or talk to people who don't know anything about investing. Our clients have direct access to IMA's decision makers by phone or email when they want to talk about their portfolios.

IMA

How We Built IMA

No bureaucracy

There's no "slow committee" in our decision-making process. If a great opportunity presents itself and we're confident in our research, we won't miss it just because we're waiting for the go-ahead from some board.

We won't do dumb things with your money

We have no institutional pressure to own a stock to hug a benchmark or just because our competitors bought it. We invest in businesses we think are good for your portfolio. Period.

International research network

We have spent several decades nurturing an international network of professional investors who help us find new opportunities or gain insights into our existing holdings. That means each of our investment decisions has been peer-reviewed for quality and safety.

No hands behind our backs

If we find a stock that we think would be great for your portfolio, why reject it simply because it doesn't fit in a particular box? We set no restrictions on style, size, or geography. It's hard enough to find good stocks as it is.

No conflicts of interest

Our only source of income is our fully disclosed management fee. We built IMA so that our profits would correlate with your wealth, ensuring we always make investment choices that are only in your best interests.

IMA

The All-Terrain Portfolio You Need for Any Economy...

Our Mission is to make sure your portfolio can grow while riding out whatever financial terrain lies ahead – including the worst. To do this, we built IMA on value investing principles outlined by Benjamin Graham and popularized by Warren Buffett. Of course, we added a twist of our own.

Built on the 6 Commandments of Value Investing +1 of Our Own

I. Treat stocks as businesses, not widgets

We take Warren Buffett's approach by asking ourselves, "Would we want to own this business if the stock market was closed for 10 years?" This makes factors like valuation, cash flows, competitive advantage, return on capital, balance sheet, and management extremely important in our analysis.

II. Have a long-term time horizon

Wall Street is obsessed with the short term, punishing stocks when their immediate future looks unattractive, and creating an opportunity to buy them at a cheaper price.

At IMA, all of our models focus on what a company will be worth in 3-5 years, based on its earnings power and cash flows. We then bring that future value forward to today at a discount rate, to see what we want to pay for this company right now.

III. The market is your servant, not your master

If you know what a business is really worth, stock fluctuations are your friend. For example, if our research shows a stock is worth $1, then if its price falls from 50 cents to 30 cents, the company can now buy back a lot more of its stock at lower prices, and we have an opportunity to increase our position.

That's why spending a lot of time doing research helps us understand what a stock's value is and enables us to rationally and calmly take advantage of price fluctuations.

IV. Leave room for error in your buy price

At IMA, we build models of businesses and stress test them to arrive at a worst-case scenario valuation. But unexpected things still happen. That's why our valuations include a margin of safety, in case we're wrong.

V. Fear permanent loss of capital, not volatility

Volatility is only scary for those who don't know what a company is worth. For those who do, the difference between business value and price provides an opportunity.

In determining a business's value, we estimate its long-term future cash flows and convert that value into today's dollars. This gives us an approximation of what the business is worth now. We then build models so that we can try to "kill" the business. We look at known risks and try to imagine unknown ones; we try to quantify their impact on cash flows.

This process helps us to determine the margin of safety that the business requires. Combining it with our valuation, we arrive at our target buy price for the stock

VI. Expect stocks to revert to fair value

If a stock is significantly undervalued for a long time, this undervaluation eventually gets cured one way or another. This reality is paramount to value investing. If we do a reasonable job at estimating what the business is worth, then, at some point, the stock market will price it accordingly.

Active Value Investing

+1

We have added to the standard value investing approach with the following principles:

- We are not traditional buy-and-forget-to-sell investors. We have strict sell criteria in order to remain "active" buy-and-sell investors.
- Given elevated market valuations and fragilities in the global economy, our margins of safety are even higher.
- We value stocks based on what they're worth, not what they used to trade at in the past.
- We don't time the market, as this strategy largely relies on luck and can't be put into a repeatable process.
- We're not afraid to hold cash if we cannot find stocks of sufficient quality.

Want More Detail?

We've attached a complete explanation of the Six Commandments in an excerpt from Vitaliy's upcoming new book. Check it out on **page 28.**

How do you build one?

As investors today we feel somewhat like a traveler preparing to cross an unknown continent in a car. A look in the rear-view mirror tells us we should pick a race car, and if the road continues to be as it has been, then our trip may be fast and uneventful. But what if the road that lies ahead is rocky, full of potholes, and maybe even strewn with giant boulders?

A sports car will not get us past the first potholes. What we need is a four-wheel-drive, all-terrain vehicle. This monster will not have the speed and the sex appeal of the shiny red sports convertible, but the heavy-duty all-terrain vehicle will complete the journey. Its position at the finish line will completely depend on one unknown – the road ahead.

If it is a smooth, unbroken surface, then our Land Cruiser will be left in the dust by the Ferraris and Maseratis in the race. It will finish the journey; it just won't be the first to cross the finish line. But if our estimate of the road ahead is correct, you're going to be mighty glad to be in the all-terrain vehicle ... and you might even finish at the head of the pack.

On the surface the US and global economy appears to have been growing, and though the growth has been slow, it has been steady. **Our concern, though, is that demand for goods globally has been highly inorganic,** engendered by global QE and unsustainable budget deficits.

Investing is a forward-looking endeavor. **We are not building a portfolio for the economy we see in the rear-view mirror but for the one that lies ahead.** Unfortunately, the view of the road ahead is very murky at best. History is not very helpful either, as the global QE experiment has never been attempted at its current magnitude.

We are building a portfolio for Mojave Desert-like terrain. Paraphrasing Warren Buffett, "To finish first, first you need to finish." Therefore, we want your portfolio to be filled with all-terrain vehicles (stocks).

Now that we have subjected you to our metaphor, let us explain what "all-terrain" means in practical terms. To do this we need to reintroduce you to our three-dimensional analytical view of stocks; Quality, Valuation, and Growth (QVG).

We'll get to Quality in a minute. The Valuation (the worth of the business) and Growth (earnings growth and dividends) dimensions have a dual purpose: they serve as a source of returns and as a protector against losses. If you buy a company that is worth $1 for 50 cents (a 50% margin of safety) and the stock goes up from

50 cents to $1 that is the Valuation dimension working as a source of returns.

On the other hand, that 50-cent investment can tolerate a lot of bad news before you lose money on the investment – that is margin of safety working to protect you against losses.

The Growth dimension protects you against the clock – time. A company that is growing earnings and paying dividends is compensating you for your time. Dividends tangibly enrich your brokerage statement on a quarterly basis. Earnings growth increases the value of the firm with the flow of time – if earnings double, that aforementioned 50 cents turns not just into $1 but into $2.

Now, how about the Quality dimension? A traditional definition of a quality company checks off these boxes: has a significant competitive advantage and high return on capital (which usually accompanies a competitive advantage); has management that is both good at running the business and at allocating capital (arguably, more value has been destroyed by poor capital allocations than by poor business decisions); and, last but not least, has a solid balance sheet – we prefer companies that have net cash on their balance sheets.

However, there is a simpler **test for what constitutes a quality company: it is one that we would be comfortable owning for five or ten years even if the stock market were closed.**

In the environment where the true cost of money is unknown (thanks to central banks) and global growth has become a Frankenstein-like creation (thank your local central banker again), then for lower-quality companies, the Valuation and Growth dimensions have lost their tangibility. You thought you were buying a $1 for 40 cents, but in the absence of Quality, Valuation can degrade much faster than your margin of safety and $1 can turn into 20 cents in a New York minute.

Quality is an uncompromising filter in our analysis – we are obsessed and dogmatic about Quality. If the company doesn't pass our Quality filter we simply stop our analysis – the company is dead to us, and we don't go to the Valuation and Growth dimensions.

Passing the Quality test doesn't make a company a buy, either, but it earns it the right for the Valuation and Growth dimensions to be examined.

Quality is the superstructure of the all-terrain company – it must survive anything thrown at it by the global economy.

IMA

How Our Investment Process Works

Our 5 Step Process

1 Find a good business

2 Imagine the worst: Still a good investment?

3 Buy it

4 Monitor the business

5 Sell it when the time is right

1 Find a good business

1. We find potential investment candidates through screens, other investors, or our watch list.

2. We ask, "Is this a high-quality business? Would we be comfortable owning it for 5-10 years if the stock market was closed?"

3. We research the business and talk to its management, suppliers, customers, as well as our own network of investment professionals

What "High-Quality" Means to Us

- Transparent, simple to understand
- Significant competitive advantage
- High recurrence of revenues
- Balance sheet a source of strength
- Management owns a lot of stock
- Well-managed
- Intelligent allocation of capital

2 Imagine the worst: Still a good investment?

1. With our research team, our proprietary methodology, and advice from specialists in the particular industry, we build a thorough model of the businesses that pass the first step of our process.

We analyze hundreds of businesses every year – but invest in only a handful of new ones.

2. Using our models, we value the business: How much will it be worth 3-5 years from now?

3. We try to "kill" the business by applying worst-case scenarios and discard it if we find it too vulnerable.

4. We arrive at the worst-case scenario valuation of the business through our analysis and stress-testing.

5. By comparing the worst-case scenario valuation and the stock's market price, we arrive at the decision to either buy the stock, keep it on our watchlist, or reject it.

3 Buy it

If we bought a stock, it means:

- Our in-depth research showed it to be a high-quality business.
- We couldn't "kill" the business (i.e., we think it'll survive the worst-case scenario).
- It's at a good price given our valuation and accounting for potential risks and a large safety margin.

We put businesses we couldn't kill but that are too highly priced on a waiting list until they reach our target price.

Purchasing a stock is just the beginning for us. We continue to further reduce your risk of investing in the new purchase through the next two steps of the investment process.

How Our Investment Process Works

4 Monitor the business

We treat purchased stocks as if we were looking at them for the first time.

We continue to research the company, build and update our models, and try to "kill" the business. If new information causes us to revalue the stock, we make sure it's still a good option for your portfolio.

And we sell the stock with no hesitation if new research shows that it's no longer a great investment.

5 Sell it when the time is right

We sell for one of 3 reasons:

1. A stock reached its full potential.

   Since stock valuation is more art than science, we avoid emotional decisions by selling half once it reaches the bottom of our target range, and the other half when it crosses the top of the range.

2. We found a better stock (that offers higher risk-adjusted returns).

3. Something went wrong.

We continuously re-evaluate our portfolio. If we discover that the assumptions in our valuation of the business were off (or something unexpected happened) such that it's no longer a good purchase, we get rid of it without hesitation.

Our Team

We are engaged in the unending pursuit of improving everything we do, from constantly refining our investment process to delivering incredible customer service to our clients.

Investment Management Team

Our portfolio managers have six decades of collective experience weathering the upturns and the downturns of the markets; each holds graduate degrees and CFA charters.

Michael L. Conn, CFA

Chairman Emeritus & Founder

Mr. Conn earned his BA from the University of Colorado at Boulder and his MBA from the Harvard University Graduate School of Business Administration. Michael has more than 40 years of investment experience.

Prior to Investment Management Associates, Mr. Conn was a vice-president and portfolio manager for Founders Capital Management and Founders Mutual Depositor Corporation. Earlier in his career he was a securities analyst with Financial Programs, Inc. and Wellington Management Company.

Mr. Conn is a CFA charterholder and has served as president and director of the CFA Society of Colorado.

Vitaliy N. Katsenelson, CFA

CEO and Chief Investment Officer

Mr. Katsenelson joined IMA in 1997. He received both his BS and MS degrees in finance from the University of Colorado at Denver.

His two books, Active Value Investing and The Little Book of Sideways Markets, were published by John Wiley & Sons and have been translated into eight languages. His articles have appeared in Barron's, Financial Times, Forbes, Business Insider, CNBC, The Globe & Mail, and MarketWatch, among others. Vitaliy has also been a guest on CNBC, Fox Business, BNN, and Yahoo! Finance.

Vitaliy has close to 20 years of investment experience and has taught a graduate investment class at the University of Colorado at Denver. He also speaks to investor organizations in the US and abroad.

Mr. Katsenelson is a CFA charterholder and has served on the board of the CFA Society of Colorado. Forbes magazine called him "the new Benjamin Graham."

He serves on the board of the Arapahoe Philharmonic.

Maksym Sirous, CFA

Research Analyst

Maksym is a research analyst at IMA. Prior to joining the firm, Maksym was a financial analyst at various investment companies in the UK, the US and Ukraine, where he worked on credit, public equity and venture capital investments.

Maksym is a CFA charterholder and has a Master's degree from Simon Kuznets Kharkiv National University of Economics.

Investment Research Network

Our clients don't just benefit from our in-depth stock analysis. We have spent several decades nurturing a wide international network of professional investors who help us find new opportunities and gain insights into our existing holdings.

With each investment decision peer-reviewed, we ensure higher quality and safety for our clients' portfolios.

We also continue to develop this network through our annual conference, VALUEx Vail.

Our Conflicts of Interest

Dear Potential Client,

Full disclosure of our conflicts of interest: **there are none.**

When we created IMA, we wanted it to be a firm that we ourselves would be happy to be clients of. So while we have a monetary interest like any other for-profit business on this planet, we aligned these interests with yours.

The monetary value of our fee goes up and down with your portfolio; thus our incentive is to grow your portfolio. If clients are not happy with IMA they can leave any time and thus stop paying us. Our incentive is to do the best job possible to grow our clients' accounts and provide incredible service to retain them.

The only fee you will pay to IMA is the management fee that we agreed upon when you became a client (found in your management agreement and each quarterly statement). Our fees are billed quarterly based on your account value on the last day of the quarter. **There are no fees to open or close an account.**

Brokerage firms don't pay us any kickbacks. We don't buy mutual funds for clients; but even if we did, they still wouldn't pay us anything to invest in them.

Wall Street is famous for manufacturing products they'd like you to buy but that they wouldn't consume themselves. We don't do that. We strongly believe in what we do and follow this philosophy: If a particular stock is good for our clients, it should be good for us.

So **we eat our own cooking.** Vitaliy's personal and family accounts (wife and three kids) are managed by IMA. Stocks that are bought or sold in your accounts are automatically bought or sold for Vitaliy's son, Jonah, his daughters, Hannah and Mia Sarah, his wife, Rachel, and Vitaliy himself. Mike Conn and his family mostly own the same stocks as his clients.

We never buy or sell stocks in our personal accounts ahead of our clients – that would be illegal and simply unethical and wrong.

We also have the incentive to grow IMA by gaining new clients. However, it is much easier to grow the firm when you retain existing clients, so that's our greatest incentive. As of October 2021 we manage $300 million. Paradoxical as it may sound, we don't have ambitions to manage billions (Vitaliy wrote about that here). At some point we will put the brakes on our growth by limiting the number of accounts we accept each quarter and/or by raising the minimum account size.

Our Conflicts of Interest

We'll strive hard to grow your wealth by following the investment process that we have developed and improved over decades. Just like any investment firm, we cannot guarantee future success. Here is what we can guarantee: **if we make mistakes they won't happen because of indifference or misaligned incentives. We are in the same boat with you** and are sailing to the same destination.

Sincerely,

Michael Conn, CFA,
Vitaliy Katsenelson, CFA, CEO

Frequently Asked Questions

Is IMA right for me?

We're not everyone's cup of tea. But we are the firm you need if you're looking for:

- Low-risk value investing oriented towards long-term growth
- Research-based, fad-free stock selection
- Full transparency about what your portfolio contains and why
- Custom-tailored portfolio and client experience
- Direct line of communication with decision makers
- No conflicts of interest
- Managers who own the same stocks as you

How do I know that my assets are secure with you?

We don't custody your assets; they are in accounts under your name with Charles Schwab or Fidelity. You have access to those accounts as if we were not involved. Our agreement gives us only a limited power of attorney to enter buy and sell orders. We cannot disburse funds.

What are your fees and minimum investment limit?

Account minimums:

Clients must invest a **minimum of $500,000*,** which can be separated into multiple accounts of **at least $250,000 each.**

Account fees:

<table>
<tr><th>INITIAL Aggregate Account Balance</th><th>$0.5 - $1mm</th><th>$1 - $2mm</th><th>$2 - $6mm</th><th>$6mm & up</th></tr>
<tr><td rowspan="2">Account Fees</td><td>1.5% on the first $1mm</td><td>1.25% on the first $1mm</td><td rowspan="2">1%</td><td rowspan="2">Fees Negotiable</td></tr>
<tr><td colspan="2">1% on the portion above $1mm</td></tr>
</table>

*international relationship minimum $1,000,000

Why do you manage each client account separately?

Unlike mutual funds, hedge funds, or ETFs, we craft individual portfolios for each client. This means that:

1. As a new client, you won't be forced to invest in appreciated stocks just because other clients hold them. We'll invest your account only into stocks that still have a significant safety margin.

2. Your unique circumstances and wishes will be accommodated. Some of our clients ask to avoid tobacco or defense stocks. Others want to take capital gains or losses for tax reasons. We make those adjustments happen.

3. You'll own your cost basis, so you won't have to pay taxes on gains enjoyed by previous investors (as often happens in mutual funds).

Why do you write such long quarterly letters?

You (the client) and we have an asymmetry of information. We have invested weeks and months of research into analysis of each stock; therefore, we have a good idea what each company is worth. You have not done this research, and you should not have to – that is what you hired us to do.

A stock price decline may cause us to rejoice, as it may lead to an increase in the gap between price and value (these things happen all the time). This decline may actually create value for you in the long run. We may be able to buy more shares on the cheap. It may also provide the company an opportunity to buy more of its own shares, increasing your portion of ownership in the company and also elevating earnings per share. And here is the best part: that happens at no cost to you. When at some point in the future the gap between price and value gets closed (i.e., the stock appreciates), the company value will be higher because of that temporary decline in stock price.

But while we are uncorking orange juice and celebrating, you may be experiencing a very different set of emotions. You may be worrying. This is why we pour our heart and soul into our quarterly letters – we want to close this informational gap and try as hard as we can to explain what we think the companies in your portfolio are worth. And if you are concerned and don't want to wait for the quarterly letter, you can simply give us a call.

How many positions do you have in your portfolios?

We typically hold 20 to 30 stocks. Our position sizes fluctuate between 2% to 6%. Most positions are in the 4-6% range (at cost). There are times when 2% or 3% positions are warranted.

For instance, a few years ago we found that stocks in the HMO industry were all cheap. There was no stock that clearly stood out as the one to buy; they all looked cheap. So rather than succumbing to decision paralysis we bought a basket: three 2% positions. Sometimes we buy a starter, a 2% position, hoping the stock declines further so we can increase to 4% or 6%, but hedging in case the stock doesn't cooperate with us and goes up. Ideally we would like to be closer to 20 positions, but lately we've been closer to 30.

When choosing how many companies we should hold in our portfolios we strive to strike a balance between two extremes: over- and under-diversification. Under-diversification – when a portfolio consists of just a few names – is dangerous because it doesn't allow room for error or randomness. We can perform a flawless analysis of a company and buy it extremely cheap, but it can get hit by a random (unpredictable) event. If that position were 20% or 30% of the portfolio, it would be hard to recover from it.

The other extreme is over diversification – something we see all the time in mutual funds that hold hundreds of stocks. Though superficially over-diversification doesn't send up any red flags, it is actually as dangerous to portfolio health as under-diversification.

In a 100-stock portfolio the average position will be 1%. If you are right on a stock and it goes up 50%, its additional contribution to the portfolio is only 0.5%; so all the hard work you did on research did not have a meaningful impact. But more importantly, if something goes wrong and the stock declines 50%, the impact on the portfolio will be only -0.5%. Now, on the surface this sounds like a great deal, an insignificant loss; but there's a problem: the fact that being wrong on an individual stock in an over-diversified portfolio carries little penalty (pain) breeds indifference, not just to one position but to all of them (indifference times a hundred!).

So what about index funds? On the surface they are over-diversified, but they don't suffer from the over-diversification headaches of managed funds. In fact, index funds are both over-diversified and under-diversified. Let's take the S&P 500 – the most popular of the bunch. It owns the 500 largest companies in the US. You'd think it was a diversified portfolio, right? Well, kind of. The top eight companies account for more than 25% of the index. Also, the construction of the index favors stocks that are usually more expensive or that have recently appreciated (it is market-cap-weighted); thus you are "diversified" across a lot of overvalued stocks. If you own hundreds of securities that are exposed to the same idiosyncratic risk, then are you really diversified?

So our approach in deciding the number of positions we own in our portfolios is very simple: we own stocks for which every decision matters, but not so few that we can't afford to be wrong on a few of them.

In addition, every company in our portfolio receives a rating based on the quality of the business, its balance sheet, the predictability of its business, and our regard for management's ability to manage the business and allocate capital (note, these are two different criteria).

A company that receives a perfect score on every measure will likely warrant close to a 6% position (if a lot of planets align we might even take it up to 8%). The lower the company's score, the lower the weight it will have in our portfolios. This rating system, combined with expected returns, helps to maximize the probability of success and naturally tilts our portfolios toward quality stocks.

Let's talk about diversification. We don't go out of our way to diversify the portfolio. At least, not in a traditional sense. But just as bank robbers rob banks because that is where the money is, value investors gravitate towards sectors where the value is. To keep our excitement (our emotions) in check, and to make sure we are not overexposed to a single industry, we set hard limits of industry exposure. These limits range from 10%–20%. We also set limits of country exposure, ranging from 7%–30% (ex-US).

Do you time markets?

It is hard, if not impossible, to create a successful market-timing process. A market timer's buy and sell decisions are made based on predicting the short-term direction of stock prices, interest rates, or the condition of the economy. This demands that you be correct twice – when you buy and when you sell – and market timing puts emotions in the driver's seat, especially at market tops and bottoms.

Instead of trying to time the market, we value individual stocks (call it timing if you like). As simplistic as it sounds, we buy stocks when they are undervalued and sell them when they are fairly valued.

As a market timer your cash balance is a function of what you think the market is about to do. Our cash balance is a by-product of investment opportunities we see in the market. If we cannot find enough stocks that meet our strict criteria, we'll hold more cash.

What is Your Sell Discipline?

Selling discipline is very important to us. It is so important that Vitaliy dedicated a chapter to it in both of his books.

An investment process without a well-defined sell discipline is as functional as a highway with only on-ramps but no off-ramps. There are three reasons to sell a stock:

1. Something has gone wrong. This will happen. We made certain assumptions about the company's fundamentals when we bought the stock – we assumed cash flow would grow at a certain rate, return on capital would be "x", or that management would make rational capital allocations. Then life happens, and we might discover that an assumption was wrong.

If so, we reexamine the stock as if we were analyzing it for the first time, asking ourselves this question: based on new information, what is the company worth? A lot of times we bought the company cheap enough that even the new bad news was already priced in, so we might do nothing (which is a decision). For every company in our portfolio we build a financial model. These models are helpful in helping understand the business not just when we buy the stock but as we continue to own it, and when things go wrong we can input the new information into our model and reassess the business.

However, if we find that, based on new information, the company isn't cheap anymore, we'll sell the stock without hesitation.

2. We simply found another stock that offers better risk-adjusted returns. This often happens, especially when we find a company in the same industry that has a lower downside but higher upside. We may then swap one stock for another. But in general, stocks in our portfolios have to compete with an external opportunity set (stocks that we don't own). Every stock in our portfolios is ranked based on the relationship of potential returns to downside risk.

3. A stock reached its full potential. Valuing a stock is more an art than a science. Therefore, for every stock in the portfolio, we don't just set a single sell price but set a price range. We continuously reassess those ranges as new information comes in.

Selling stocks that have done well for us is very difficult psychologically, as there is significant attachment that develops with such companies. To overcome this psychological attachment, we put our sell process almost on autopilot: once a stock price crosses the low point of our sell range we sell half, and then when it crosses the top of the range we sell the other half.

What does your turnover look like?

Despite active being in the name of our strategy, we are not traders; we are investors. The word active amplifies the importance of our sell discipline. We are not buy-and-hold investors; we are buy-and-sell investors. Just because we've bought a stock doesn't mean we'll hold it forever – it has to deserve to stay in the portfolio. It still has to continue offering a compelling risk-adjusted return for us to go on holding it. It is hard to precisely measure the turnover of our portfolio, but we guestimate it to be around 30% a year.

We have owned many companies for longer than five years, and some we owned for less than a year (though this happens less often). When we analyze companies we look at them not as pieces of paper but as businesses we intend to own for a long period of time.

Why do you love market volatility?

Conventional wisdom views volatility as risk. We don't. We befriend it, embrace it, and try to take advantage of it. The true risk is not volatility but permanent loss of capital. For someone who has not researched a company, it is not readily apparent whether a decline in shares is temporary or permanent. After all, if you don't know what the company is worth, the quoted price becomes the measure of intrinsic value.

If you know what the company is worth, then change in intrinsic value is all that is going to matter. The price quoted on the exchange will be your friend, allowing you to take advantage of the difference between intrinsic value and the quoted stock price. If the quoted price is significantly cheaper than your estimated intrinsic value, you buy the stock or buy more of it if you already own it. If the opposite is true, you sell it.

How much time do you spend on macro forecasting?

Usually, macro forecasting is frowned upon in the value investing community, and Warren Buffett has everything to do with that. He is famous for saying, "My decision making would not change even if I knew what the Federal Reserve will do with interest rates next month." There is sound logic behind this: Forecasting the economy is incredibly difficult in the short run.

As an investor you want to spend very little time on forecasting the weather (that is, what the Fed will do with interest rates next month or the rate of growth of the economy). Weather forecasting, first of all, is not always accurate, but it will certainly consume a lot of time and energy, and the forecasts have a very finite shelf life. Yesterday's weather is irrelevant today. As long as you own companies that can survive rain — even a few weeks of rain — without catching pneumonia, weather forecasting is a waste of time. This is what Buffett was implying by saying he didn't want to be a macro forecaster.

Instead of being a weatherman, we pay serious attention to "climate change" — significant shifts in the global economy that can impact your portfolio.

How many people make the investment decisions at your firm?

All investment decisions at IMA are made by Vitaliy Katsenelson and Michael Conn. Vitaliy is the lead manager for the Active Value strategy.

We also employ three to four analysts (apprentices) from local universities (usually finance students) who under Vitaliy's direction build models and help us with research. In addition, we have a network of five dozen investors globally with whom we share ideas: They provide feedback on our ideas and are a great source of new investment ideas.

What sort of style box do you fit into? Large vs. small-cap, growth vs. value?

We don't voluntarily lock ourselves into any box. We are looking to own great businesses at ridiculously low prices. They can be of any size (as long as they are liquid); we'll look for them in any country (that operates by the rule of law); and they can be "growth" or "value" as long as they are cheap.

What percentage of your portfolio is domestic/international?

This will vary depending on the opportunities we see at any point in the US and foreign countries. Currently about two-thirds of the portfolio is in the US and one-third is outside. But we can see the ratio shifting toward fifty-fifty.

How often do you review positions in your portfolio?

We revisit each company at least quarterly as we listen to the company's conference calls, read its quarterly reports, and update our models. But it's really a continuous process. We read the news flow and think constantly about the stocks we own.

IMA

Different Goals, Same Investing Principles

Whether you're looking for growth or income, our portfolios are still all-terrain, crisis-resistant, long-term oriented, and built on our Active Value Investing principles.

	Active Value Investing Core Portfolio	Active Value Investing Dividend Portfolio
Tailored to	Portfolio growth	Stable and rising income stream
Total return objective (price + dividend)	High	Medium
Dividend-paying stocks	✓	✓
Non-dividend-paying stocks	✓	✗
Only high-quality, resilient businesses	✓	✓ (extra emphasis on stability of cash flows)
Stock undervaluation (margin of safety)	Very significant	Significant
Custom-tailored portfolios	✓	✓
Option to avoid specific industries	✓	✓
Know what's in your portfolio and why	✓	✓
Managers own the same stocks	✓	✓
Number of stocks	25 - 30	25 - 30
Fees	See our fee schedule on page 17	

Designed to be "All-Terrain"

Every single portfolio that we create at IMA is, without exception, based on the same Active Value Investing principles that we've covered earlier in this brochure. Each is designed to be "all-terrain", to do as our motto says: grow your wealth while protecting you from worrying about the ups and downs of the market. Each is designed to achieve different goals.

In our Active Value Investing (AVI) Core Portfolio we implement our approach without any restraints. Its main objective is to maximize your assets' long-term growth.

The AVI Dividend Portfolio's objective is to generate a stable and rising income stream in any economic environment, so it's limited to dividend-paying stocks only. Still, like any IMA portfolio, it is based on the principle of "do no harm."

In a world where interest rates are at zero or negative, there is an insatiable demand for income. And knowing Wall Street, where there is thirst there will be water, even if it's polluted. This has long been our feeling about income-producing products and services (including newsletters): We'd look at their holdings and see sheep (clients) lining up to an eventual slaughter, as either quality or valuation (or both) was sacrificed to build those portfolios.

In the creation of our Dividend Portfolio, we flipped Wall Street logic on its ear. Instead of seeing dividends as a shiny, mesmerizing object that drives our decisions in portfolio construction, we make them the last thing we consider.

How We Build the Dividend Portfolio

We select a global universe of dividend-paying stocks. Then we identify high-quality, resilient businesses. These are usually businesses with little cyclicality, strong balance sheets, and a sustainable competitive advantage, and they are run by good management.

Then we value them. They have to be significantly undervalued to be considered. In other words, we want to identify great businesses that will provide returns from both dividends and stock appreciation. We want to own companies that are paying their dividends with ease and not pawning their future to satiate the immediate needs of dividend-hungry investors.

To be clear, we are not focusing on minimizing volatility. This portfolio is full of stocks, and the stock market gods are in control of volatility. We want the purchasing power of this portfolio to increase over time. The ultimate goal of the portfolio is to produce a stable and growing income stream, come hell or high water, in any economy.

This portfolio generally has 25 to 30 stocks. In our construction we apply diversification constraints, which vary by industry and country.

How is this portfolio different from our Core Portfolio?

There is some overlap – some of the stocks will be in both portfolios. But there are differences, too. The Core Portfolio is not constrained by the dividend requirement. In the Dividend Portfolio we focus on companies that can produce a dividend in any economy, which at times leads us to slower-growing but more predictable types of businesses.

Finally, our required rate of return requirement is lower for Dividend than for Core stocks. For instance, if we require a 15% total return (the combination of stock appreciation and dividends) for a company to make it into the Core Portfolio, a similar company only needs to produce a 12% total return to qualify for the Dividend Portfolio.

How To Invest With Us

All You Need To Do

1 Read this brochure

Make sure to read about our investment process and check out the FAQs

2 Get in touch

Call us at **(303) 796-8333** or email us at **contact@imausa.com**. You can also ask us to contact you.

What We Will Do

1 We'll make sure IMA is a good fit for you

In our first phone call we'll go over what you're looking for and whether our investment services are the right match for your needs.

2 We'll walk you through our investment process

If IMA is right for you, we'll walk you step-by-step through how we value companies, build models, and put the portfolio together.

3 We'll help you do all the paperwork

We'll help you set up brokerage accounts and fill out the necessary agreements to start investing with us.

Bonus: The Six Commandments of Value Investing

The following text is an excerpt from IMA CEO Vitaliy Katsenelson's upcoming book, The Intellectual Investor. It's a thorough explanation of IMA's guiding active value investing principles, so we hope you'll enjoy the read.

I wrote the core of this chapter in preparation for a speech I gave at an investment conference. In my speech, I wanted to show how at my firm, we took the Six Commandments of Value Investing and embedded them in our investment operating system.

Since I was speaking to fellow value investors, this speech was written not to promote my firm but to educate. I was going to rewrite the speech for this chapter and make a bit less about us and more about you –but each attempt resulted in a dull chapter. So here is a much extended version of my original speech.

We want to ask you a favor: Though we want you to feel free to share this chapter with your colleagues and friends, please do not repost it on the web in any form.

The Six Commandments

I. A stock is fractional ownership of a business (not trading sardines).
II. Long-term time horizon (both analytical and expectation to hold)
III. Mr. Market is there to serve us (know who's the boss).
IV. Margin of safety – leave room in your buy price for being wrong.
V. Risk is permanent loss of capital (not volatility).
VI. In the long run stocks revert to their fair value.

These are the Six Commandments of Value Investing. I don't expect any value investors reading this to be surprised by any one of them. They were brought down from the mountain by Ben Graham in his book Security Analysis. These commandments are very important and they sound great, but in the chaos of our daily lives it is so easy for them to turn into empty slogans.

A slogan without execution is a lie. For these "slogans" not to be lies, we need to deeply embed them in our investment operating system – our analytical framework and our daily routines – and act on them.

Let me tell you how we utilize the Six Commandments in our investment operating system at IMA:

Bonus: The Six Commandments of Value Investing

I. A stock is partial ownership of a business.

The US and most foreign markets we invest in are very liquid. We can sell any stock in our portfolios with ease – a few clicks and a few cents per share commission and it's gone. This instant liquidity, though it can be tremendously beneficial (we wish selling a house were that easy, fast, and cheap), can also have harmful unintended consequences: It tends to shrink the investor's analytical time horizon and often transforms investors into pseudo-investors.

For true traders, stocks are not businesses but trading widgets. Pork bellies, orange futures, stocks are all the same to them. Traders try to find some kind of order or a pattern in the hourly and daily chaos (randomness) of financial markets. As an investor, I cannot relate to traders –not only do we not belong to the same religion, we live in very different universes.

Over the years I've met many traders, and I count a few as my dear friends. None of them confuse what they do with investing. In fact, traders are very explicit that their rules of engagement with stocks are very different from those of investors.

I have little insight to share with traders in these pages. My message is really to market participants who on the surface look at stocks as if they were investments but who have been morphed by the allure of the market's instant liquidity into pseudo-investors. They are not quite traders – because they don't use traders' tools and are not trying to find order in the daily noise – but they aren't investors, either, because their time horizon has been shrunk and their analysis deformed by market liquidity.

The best way to contrast the investor with the pseudo-investor is by explaining what an investor is. A true investor would do the same analysis of a public company that he would do for a private one. He'd analyze the company's business, guesti-mate earnings power and cash flows. Assess its moat – the ability to protect cash flows from competition. Try to look "around the corner" to various risks. Then figure out what the business is worth and decide what price he'd want to pay for it (your required discount to what the business is worth). For an investor, the analysis would be the same if his $100,000 was buying 20% of a private business or 0.002% of a public one. This is how your rational uncle would analyze a business – your Warren Buffett or Ben Graham.

How do we maintain this rational attitude and prevent the stock market from turning us into pseudo-investors? Very simple. We start by asking, "Would we want to own this business if the stock market was closed for 10 years?" (Thank you, Warren Buffett). This simple question changes how we look at stocks.

Now, the immediate liquidity that is so alluring in a stock, and that turns investors into pseudo-investors, is gone from our analysis. Suddenly, quality – valuation, cash flows, competitive advantage, return on capital, balance sheet, management – has a much different, more complete meaning.

II. Long-term time horizon (both analytical and expectation to hold)

A long-term time horizon is extremely important for value investors for several reasons: First, it is impossible predict how a stock will be priced in the short run. Short-term stock behavior is random, and thus its forecasting (at least using tools available to investors) cannot be turned into a repeatable process.

Second, having a longer time horizon than Wall Street is a very important competitive advantage. The Street's time horizon is very short – measured in months, maybe quarters, but rarely in years.

Money flows into mutual funds and hedge funds are driven by recent performance, so Wall Street is obsessed with the short term. This creates time arbitrage. Stocks get punished because their immediate future may look unattractive, but if you look at them as businesses, that short-term performance is just a pimple on your long-term timeline.

So, how do we embed a long-term time horizon into our process?

First, we always look at earnings and cash flows at least three (often five) years out. This forces us to look at the company's normalized earnings power and ignores the short term. All our models focus on what the company will be worth based on its earnings power in three to five years. Then we discount (bring that future value forward to today at an 18%-40% discount rate, depending on the company's quality) to see what we want to pay for this company today. Looking at the business at least three to five years out has a very important side effect: It adds "growth" to the portfolio from earnings and dividends. Stocks returns for comes from three sources: price-to-earnings (P/E) expansion, earnings growth, and dividends.

P/E expansion is finite – it's a one-time shot in the arm. Let's say a stock's P/E goes from an undervalued 12 to a fairly valued 15 – a 25% return. If this company doesn't grow earnings and/or pay dividends, that 25% will be our total return. The risk of owning this type of "one-shot" stock is that without earnings growth or dividends, time is not on your side – you don't get paid to wait.

If your time horizon is three years, that 25% return gets truncated to an annual return of only 8% a year. But if this company, in addition to trading at a depressed P/E, pays a 3% dividend and grows earnings 7% a year, that is an additional, repeatable 10% return a year. This elongation of the time horizon embeds growth in our portfolio and also forces us to demand a much higher discount for stocks that don't pay dividends and don't grow their earnings.

III. The market is there to serve you, not the other way around.

The market is there to price stocks on a daily basis, but it doesn't value them on a daily basis. In the long run (the yardstick here is years, not days or months) the market will value stocks, but in the short run stock price movements are random.

Despite this randomness, the media will always find a rational explanation for a move. However, trying to understand randomness and predict stock movements in the short run is like trying to have an intelligent conversation with a two-year-old. It may be fun, but it will consume a lot of your time and energy, and the outcome is far from certain.

Stock fluctuations should be looked upon as a natural and benign feature of the stock market, but only if you know what the asset is worth. To make Mr. Market serve us and not become its slave, here is what we do.

If we know a stock is worth $1, then if its price falls from 50 cents to 30 cents (a 40% decline), that's a blessing for several reasons: The company can now buy back a lot more of its stock at lower prices, and we can add to our position. After all, it's 40% cheaper.

Here is the key, though: You have to make sure that what you thought was worth $1 is still worth $1.

To quote Mike Tyson, "Everyone has a plan till they get punched in the mouth." How do you remain rational when Mr. Market has just smashed you in the face by repricing your $1 stock from 50 cents to 30 cents? Maybe Mr. Market is right and that company's fair value was never really $1 but only 40 cents?

To remain rational, we focus on maximizing our Total IQ. I know we were not supposed to have math, especially this early in the book. But indulge me with this little equation:

$$\text{Total IQ} = \text{IQ} \times \text{EQ} \quad (\text{where EQ} \le 1)$$

Before I explain I want to stress this point: Your IQ, EQ, and thus Total IQ will vary from stock to stock and from industry to industry.

Let's start with IQ.

IQ – our intellectual capacity to analyze problems – will vary with the problem in front of us. Just as we breezed through some subjects in college and struggled with others, our ability to understand the current and future dynamics of various companies and industries will fluctuate as well. This is why we buy stocks that fall within our sphere of competence. We tend to stick with ones where our IQ is the highest.

As I have mentioned before but will continue to repeat: If investing were an exact science – a formulaic process by which you could (in a vacuum) constantly test and retest your hypotheses and repeat your results – then EQ, our emotional quotient, would be irrelevant.

If we were characters from Star Trek – with complete control over our emotions, like Mr. Spock, or lacking emotions entirely, like Lieutenant Commander Data – then our EQ wouldn't matter. However, investing is not a science and we are humans. We have plenty of emotions, and thus EQ is a very important part of this equation.

Though we usually think about our capacity to analyze problems as being dependable and stable over time, it isn't.

First, emotions distort probabilities. So, even if my intellectual capacity to analyze a problem is not impacted, my brain may be solving a distorted problem.

Second, my IQ is not constant, and my ability to process information effectively declines under emotional stress. I either lose the big picture or overlook important details. This dilemma is not unique to me; I'm sure it affects all of us to varying degrees.

A friend of mine who is a terrific investor, and who will remain nameless (though his name is George), once told me that he never invests in grocery store stocks because he can't be rational when he holds them. If we spent some Freudian time with him, we'd probably discover that he experienced a traumatic childhood event at the grocery store (he may have been caught shoplifting a candy bar when he was eight), or he may have had a bad experience with a grocery stock early in his career. The reason for his problem is irrelevant, though. What is important is that he has realized that his high IQ will be impaired by his low EQ if he owns grocery stocks.

The higher my EQ is with regard to a particular company, the more likely my Total

IQ will not degrade when things go wrong (or even when they go right). This is why in the little formula above, EQ cannot be greater than 1. In your most emotionally stable state (when EQ = 1), your Total IQ will equal your IQ.There is a good reason why doctors don't treat their own children: Their ability to be rational (properly weighing probabilities) may be severely compromised by their emotions.

Now, how do we increase our Total IQ?

First, we increase it by subtraction, by shrinking our universe to stocks that lie within both our IQ and EQ comfort zones.

We are very careful about stocks or industries where either our IQ or EQ is questionable. For instance, we have recognized that our IQ is low when it comes to non-revenue-generating, single-future-product biotech companies. We have zero analytical insights into this business. None.

We find that our EQ is fairly low when it comes to complex financial businesses. We don't invest in any.

The beauty of investing is that we only need 20-30 stocks, and we get to choose which problems we want to tackle. We usually like easy problems.

In other professions, that is a luxury you don't have. If you are an orthopedic surgeon, you are not going to tell your patient that you only operate on right knees because the last time out you had a bad experience with a left knee.

Second, we look for areas where our EQ is highest.

Over the years, we've discovered that our EQ is much higher with higher-quality companies. Therefore, for every company in our portfolio or on our watch list, we quantify quality. And with very rare exceptions, we own only very-high-quality companies.

We quantify quality for another reason, too. As value investors, we are innately focused on a margin of safety. We found that if you don't quantify quality, it is very easy to lower your standards when you reach for value, especially in a very expensive market.

We went a step further: Quality, for us, is a filter. If a company doesn't pass its quality test, it is dead to us. It may have high growth prospects, pay high dividends, and it may sell at a mouthwatering valuation. But if it failed our quality test, it is still dead to us.

By quantifying quality, we can keep the overall quality of our portfolio very high. Just as importantly, we can keep our EQ high, too.

By maximizing both our IQ and EQ for individual stocks, we maximize the Total IQ of the portfolio. Thus, when we get punched in the mouth, we are able to rationally reanalyze a stock and may decide to buy more, do nothing, or sell.

We cautiously guard our EQ and long-term horizon. We don't let the outside world come unchecked into our daily life. For instance, we spend little time watching business TV during the day, as we find it to be toxic to our time horizon and to our investor (as opposed to trader) mentality. For the same reason, we also don't look at our portfolio more than twice a day.

Finally, and this applies to professional investors only, you need to have clients who will allow you to maintain your EQ. Following the Six Commandments is practically impossible if your clients don't believe in them.

Here's a real example:

On January 25th, 2013 at 3:55 pm I got this email from a client, David:

From: David [redacted]
[mailto:David.[redacted]]
Sent: Friday, January 25, 2013 3:55 PM
To: Vitaliy Katsenelson
Subject: RE: Apple trade in David [redacted] account

Dear Vitaliy,

I just noticed that you bought Apple. I feel this was an irresponsible purchase and want you to cancel the trade first thing Monday morning. This is a stock that is coming off a one year top and is heading down. You should not be trying to pick up a falling star.

Thank you,
David

David and I talked on the phone, and I tried to explain our logic. I'm not going to bore you with that, but it was along the lines of "incredible brand, high recurrence of revenues, great management, a quarter of market capitalization in cash; we tried to kill it (we lowered its margins, cut sales) and we simply couldn't."

I told David that the price of the stock is an opinion of value, not a final verdict – he didn't care. He'd talked to his neighbor who was a famous technician, who said, "Apple is going down." To which my response was, "If it declines that will be a blessing – the company is buying back stock, and we are going to buy more."

The "technician" was right: Apple declined from $455 ($65 split-adjusted), our initial purchase price, to $395 ($56 split-adjusted). We bought more Apple as it fell. This encounter also made me realize how this negative psychology around Apple was creating an opportunity in Apple, and I wrote a two-part article describing the aforementioned incident as evidence of that.

What I did not say in that article is that we had to amicably part ways with David. I tried very hard to communicate the Six Commandments to him, but he was not willing to (re)learn. Keeping him as a client would erode my overall EQ and would have impacted other clients.

Your mental state is as important as your ability to analyze a company's balance sheet or your ability to value the business. You may spend days sharpening your investment process, your analytical skills; but in the end, if your EQ is low nothing else will matter.

IV. Margin of safety – leave room in your buy price for being wrong.

Margin of safety is a function of two dimensions: a company's quality and its growth.

I am generalizing here, but exogenous events have a greater impact on a lower-quality business than a higher-quality one. Thus a high-quality company needs a lower margin of safety than a lower-quality one.

A company that is growing earnings and paying dividends has time on its side and thus may not need as much margin of safety as a lower-growing one.

We quantify both a company's quality and growth, and thus margin of safety is deeply embedded in our investment operating system.

The larger discount to the stock's fair value (the $1) the less clairvoyance you need to have about the future of the business. For instance, in 2013, when Apple stock was trading at $400 (pre-split) we didn't have to have a very clear crystal ball about Apple's future; Apple just had to be able to barely fog the mirror. In later years, at $900, we need to have a lot more precision in our analysis of Apple's future.

V. Risk is a permanent loss of capital (not volatility).

Conventional wisdom views volatility as risk. Not value investors. We befriend volatility, embrace it, and try to take advantage of it. For someone who has not researched a company, it is not readily apparent whether a decline in shares is temporary or permanent. After all, if you don't know what the company is worth, the quoted price becomes the quotient of intrinsic value.If you do know what the company is worth, then the change in intrinsic value is all that is going to matter. The price quoted on the exchange will be your friend, allowing you to take advantage of the difference between intrinsic value and quoted stock price. If the quoted stock price is significantly cheaper than your estimated intrinsic value, you buy it (or buy more of it if you already own it). If the opposite is true, you sell it.

What is a company worth? Determining the intrinsic value requires a combination of art and science, in that order – it is not quoted on the exchanges. We go about this the same way a businessman would figure how much he'd want to pay for a gas station or a McDonald's franchise.

Analysis of each company will be different, but at the core we estimate the cash flows the business will produce for shareholders in the long run (at least ten years) and what the business will be worth then (based on our estimate of its earnings power at the time). The combination of the two provides us an approximation of what the business is worth now.

To further embed "the right" type of risk analysis into our investment operating system, we build financial models. Models help us to understand businesses better and provide insights as to which metrics matter and which don't. They allow us to stress test the business: We don't just look at the upside but spend a lot of times looking at the downside – we try to "kill" the business. We look at known risks and try to imagine unknown ones; we try to quantify their impact on cash flows.

This "killing" helps to us understand how much of a discount (margin of safety) we should demand to what the business is worth. By applying this discount to fair value, we arrive at a buy price. For every stock we buy we probably look at a few dozen (at least).

For instance, if we are looking at a company that is selling products or services to consumers, we'll be focusing on customer-acquisition costs. We try to drill down to the essential operating metrics of each company. If it's a convenience store retailer, we'll look into gallons of gas sold and profit per gallon. If it's an oil driller, we'll look at utilization rates, rigs in service, average revenue per rig per day. If it's a pharmaceuticals company, we'll have revenue lines for each major drug it sells and model the company for the eventuality that patents will run out. (Revenues usually decline 80-90% when a patent expires.)

These models help us to understand the economics of the business.

We usually build two type of models. We start with what we call the "tablecloth" model. This is a very detailed, in-depth model that zeros in on different aspects of the business. But the risk we run with a tablecloth model is that we get lost in the trees and forget about the forest. This brings us to our "napkin" model. It's a much simpler and smaller model that focuses only on the essentials of the business. It is easier to build the tablecloth model than the "napkin." If we can build a napkin model, that means we understand the drivers of the business – we understand what matters.

Models are important because they help us remain rational. It is only the matter of time before a stock we own will "blow up" (or, in layman's terms, decline). In this type of analysis, what happens this month, this quarter, or even this year is unimportant in the context of the long run – unless the company's good or bad earnings report in any quarter changes our assumptions on the company's long-term cash flows. If you methodically focus on what the company is worth and if your Total IQ is maximized, then price fluctuations are just noise. Volatility becomes your friend because you can rationally take advantage of it. It's an underappreciated gift from Mr. Market.

Side note: As an advisor, I feel it is one of my great responsibilities to be an honest and clear communicator. There is an asymmetry of information between us and our clients. We have invested weeks and months of research into the analysis of each stock; therefore, we have a good idea what each company is worth. Our clients have not done this research, and they should not have to – that is what they hired us to do.

This is why we pour our heart and soul into our quarterly letters – we want to close this informational gap and so we try as hard as we can to explain what we think the companies in our portfolio are worth. Our letters are often 15-20 pages long.

VI. In the long run, stocks revert to their fair value

Reversion to fair value is not a pie in the sky concept. If a stock is significantly undervalued for a long time, then this undervaluation gets cured, eventually. That can happen through share buybacks – the company can basically buy all of its shares and take itself private.

Or it can happen by the company's paying out its earnings in dividends, thus creating yields that the market will not be able to ignore. Or the company's competitors will realize that it is cheaper for them to buy the company than to replicate its assets on their own. Either way, undervaluation gets cured.

This faith that undervaluation will not last forever is paramount to value investing. But this is not your regular faith, which requires belief without proof. This is evidence-supported faith with hundreds years of data to back it. Just look at the US stock market: it has gone through cycles when it was incredibly cheap and others when it was incredibly expensive. At some points in its journey from one extreme to the other, it touched its fair value, even if it was transitory.

Historically, value investing (owning undervalued companies) has done significantly better than other strategies. Paradoxically, the reason it has done well in the long run is because it did not work consistently in the short run. If something works consistently (keyword), everybody piles into it and it stops working.

These aforementioned cycles of temporary brilliance and dumbness are not just common to us mere mortals. Even Warren Buffett's Berkshire Hathaway goes through them. As just one example, in 1999, when the stock market went up 21%, Berkshire Hathaway stock declined 19%. In 1999, the financial press was writing obituaries for Buffett's investment prowess. Suddenly, in 1999, Buffett's IQ was lagging the market by 40%. At the time, investors were infatuated with internet stocks that were not making money but that were supposed to have a bright future. Investors were selling unsexy "old economy" stocks that Buffett owned in order to buy the "new economy" ones.

If at the end of 1999, you were to sell Berkshire Hathaway and buy the S&P 500 instead, you would have done the easy thing, but it would have been a large (though very common) mistake. Over the next three years Berkshire Hathaway gained over 30% while the S&P declined over 40%. During the year 1999, Buffett's IQ did not change much; in fact, the (book) value of businesses Berkshire Hathaway owned went up by 0.5% that year. But in 1999, the market's attention was somewhere else and it chose to price Berkshire Hathaway 19% lower.
As a value investor, if you do a reasonable job estimating what the business is worth, then at some point the stock market will price it accordingly. You need to have faith. I am acutely aware how wishful this statement sounds. But this faith, the belief in mean reversion, has to be deeply ingrained in our psyche. It will allow us to remain rational when people around us are not.

Conclusion

I read somewhere that chess is a game of small advantages. When the game starts, the players are equal – both hold the same number of pieces in the same positions. But then every move either adds to your position (competitive advantage) or subtracts from it. These little decisions (resulting in a better pawn structure, a more secure king, a centrally positioned knight, and so on) that you make with every move accumulate into victory.

Investing is not that much different, especially in today's world where access to information has flattened. A mutual fund that manages $100 billion may spend $100 million on research, but that $100 million doesn't buy any more than what a patient value investor can glean by reading financial statements.

I am not talking about Warren Buffett either, who doesn't even have a PC in his office. Ted Weschler and Todd Combs (Warren Buffett's right-hand men) achieved phenomenal investment success without a fancy research department by simply reading carefully and following our Six Commandments.

The key to succeeding in this irrational world is to actively ingrain each one of these principles into your investment operating system, improving your process just a little on a daily basis, and then success will follow.

Finally, this would not be a worthy chapter if I did not contradict myself, just a little. Investing is also unlike chess. Investing affords us a luxury that few people appreciate: You can choose your own opponent. In chess tournaments, you don't get to choose your opponent. Tournament organizers match you to someone with an equal rating; then as you win, you are progressively matched against better opponents.

In investing, you are the "tournament organizer." You get to walk into the room and, instead of choosing the geekiest opponent – the dude with thick glasses who hasn't been on a date in years and has only thought and dreamt about chess – you can go for the muscular guy who spends five hours a day in the gym, and only joined the tournament because he lost a bet. Money doesn't know how you made it. A hundred dollars made by solving easy problems (buying stocks where both your IQ and EQ were at their highest) buys as much as a hundred dollars that caused you to lose your hair. In investing, you don't have to solve the problems that everyone else is solving. There are thousands of stocks out there, and your portfolio needs only a few dozen.