Investment Judgement (Hedge Funds)

Interview preparation summary · HF track

IN THIS SUMMARY

- Is there an edge
- Good long or good short
- Risk, sizing and when you are wrong

INT.HJ.1.a · Is there an edge

State a variant perception: what consensus believes, how your view differs, why consensus may be wrong, and what evidence will show it.

An edge is a difference between what you expect and what the market expects, supported by a reason and a way to prove it. A variant perception has four parts: what consensus believes (use published estimates, the guidance and the price itself), what you believe and by how much, why the market may be wrong, and what will close the gap and when. The reason matters, because a gap with no explanation is usually your error. Common reasons are a better data source, a structural change the market treats as temporary, forced or uninformed sellers, neglect of a small or complex company, and a time horizon longer than the typical holder. Quantify the gap in earnings per share and in price, because a small difference in revenue can be worth little, and an interviewer will test whether your edge is large enough to matter. The usual mistakes are calling a widely held bearish or bullish view an edge, and confusing a good company with a mispriced one.

WORKED EXAMPLE: SIZING A VARIANT VIEW ON A LOGISTICS COMPANY

Fenwick Logistics is an invented warehouse and freight company with last year revenue of 1,000m, 50m shares and a share price of 16.47. Consensus expects revenue growth of 4% and an operating margin of 8.0%. Your data on warehouse occupancy in its main regions suggests growth of 7%, and each extra pound of revenue earns an incremental margin of 20%. Interest is 10m, tax is 25%, and the shares trade on 15 times earnings. Is this a worthwhile variant view?

Answer: Consensus EPS is 1.098 and mine is 1.188, a gap of 8.2%, which is worth about 1.35 a share at an unchanged multiple. The reason is that analysts anchor on guidance and miss occupancy data, and the half-year result will test it. It is a real but modest edge, so I would size it small unless revisions can also lift the multiple.

> **Interview tip:** Quote the gap in earnings per share and in price, say why the market is wrong, and name the date of the proof. Being honest that the edge is modest scores better than inflating it.

INT.HJ.1.b · Is there an edge

Reverse a share price into market expectations: work out what growth, margin or duration of growth the price assumes, and compare it with your own forecast.

Before asking what a stock is worth, ask what has to happen for today's price to be right. Take the price and solve for the one assumption you are least sure of while holding the others fixed: the earnings growth needed to earn your required return over five years, the margin implied by a fair multiple, or the perpetual growth rate in a cash flow yield. Then compare that implied figure with history, peers, management guidance and your own work. If the price needs growth above anything the company has delivered, the expectation is demanding and the stock is a candidate for a short or an avoid. If it assumes a collapse that the order book and balance sheet do not support, it may be a long. The method also tells you what consensus is, because consensus is what makes the price fair. Common mistakes are using an exit multiple that is too high, forgetting dividends or dilution, and treating the implied number as a forecast when it is only a test.

WORKED EXAMPLE: WHAT DOES A 30 TIMES EARNINGS MULTIPLE REQUIRE?

Dunmore Systems is an invented software company. The share price is 45.00, earnings per share are 1.50 (30 times), and you want a return of 10% a year over five years. Assume no dividends, and that in five years the shares will trade on 20 times earnings as growth matures. Consensus expects earnings growth of 15% a year. What growth does the price require, and what do you earn if consensus is met?

Answer: The price needs about 19% a year of earnings growth for five years to earn 10%, while consensus is 15%, which yields only about 6%. So the stock is priced above consensus, and I would not be long without evidence that growth will beat it.

> **Interview tip:** Say what you solved for, what you held fixed, and what the answer is compared with. Then say what it means for the call.

INT.HJ.2.a · Good long or good short

Judge whether a company is a good long or a good short by weighing quality and durability against valuation, and explain why cheap is not the same as good.

A good company and a good investment are different things, and the price is the link. Start with quality and durability: return on invested capital against the cost of capital, the reasons it can last (pricing power, switching costs, scale), and the direction of the earnings, not just the level. Then value the company against peers and its own history, but adjust the multiple for growth, returns, capital intensity and leverage, because a low multiple on falling or capital-hungry earnings can be expensive. Always ask why it is cheap or expensive: if the discount reflects a real structural decline, it is a value trap, and if the premium reflects a strong, lasting franchise, it is not automatically a short. The comparison with history is only useful if the business has not changed. A good long is a durable business priced for less than it will earn, and a good short is a deteriorating or overvalued business where the price assumes the opposite.

WORKED EXAMPLE: A CHEAP MULTIPLE THAT IS NOT CHEAP

Draycott Home Stores is an invented department store group. Enterprise value is 600m, EBITDA is 100m, capex needed to keep the stores competitive is 80m and EBITDA is falling about 5% a year. A peer group trades at 9.0 times EBITDA with capex of 40% of EBITDA. The 10-year average for Draycott is 8 times. Is Draycott cheap?

Answer: Draycott looks 33% cheaper than peers on EBITDA but is twice as expensive on cash earnings, 30 times against about 15 times, and the earnings are falling. Cheap on the headline multiple is not the same as a good long, and I would want the capital spending and the direction of earnings explained before calling it good.

> **Interview tip:** Always name the adjustment that reverses the apparent discount, and say whether the business or the price has changed since the historical average.

INT.HJ.2.b · Good long or good short

Test earnings quality and the balance sheet, set catalysts and a timeline, and for a short cost the borrow and judge the squeeze risk.

Earnings quality asks whether reported profit turns into cash. Compare cash flow from operations with net income, watch receivables and inventory growing faster than sales, check capitalised costs, one-off gains and stock-based pay, and look at deferred revenue as a guide to future sales. The balance sheet decides whether time is on your side: net debt to EBITDA, interest cover, maturities and covenants. Every idea also needs a catalyst and a timeline, since a mispricing with no event can last longer than a fund can wait. A short has extra costs and risks. The borrow fee and any dividends are paid every day the position is open, the loss on a rise is not capped, and a crowded short (high short interest relative to free float, many days to cover, a cheap stock with a catalyst) can be squeezed. Check the fee, the free float and the number of days needed to buy back the position at normal volume. A good short pairs deteriorating quality with a dated catalyst and a cost that the expected fall can cover.

WORKED EXAMPLE: IS PELHAM MEDICAL STAFFING A GOOD SHORT?

Pelham Medical Staffing is an invented agency. Revenue grew from 680m to 800m, receivables rose from 112m to 168m, net income was 72m and operating cash flow was 40m. The borrow fee is 6% a year, you expect to hold for nine months, and you think the shares can fall 25% when a customer audit reports. Is the quality poor, and does the short pay?

Answer: Quality is poor: days outstanding rose from 60 to 77, an excess of 36m of receivables equal to half of earnings, and cash conversion is 56%. With a dated audit catalyst and a borrow cost of about 4.5% for the period against a 25% expected fall, the short pays, provided squeeze risk is checked and the size is limited.

> **Interview tip:** Name the cash flow test, the catalyst and the carry cost in that order, then the squeeze check. A short without a cost estimate is incomplete.

INT.HJ.3.a · Risk, sizing and when you are wrong

Weigh risk and reward using the skew between upside and downside, then size the position by the loss in the bad case and fit it to the portfolio.

Risk/reward is the size of the gain if you are right against the loss if you are wrong, weighted by how likely each is. Build three or four scenarios (bull, base, bear and sometimes a tail) with a price and a probability for each, compute the expected return, and then separate the gains from the losses to get a reward to risk ratio. A ratio looks good only if the probabilities are credible; a 50% upside is not attractive if the probability of a 40% loss is high. Position size should come from the loss in the bad case, not from conviction alone: divide the loss you are willing to take on a position, as a share of capital, by the percentage fall to the bear price. Then limit the size by liquidity (how many days to exit at a sensible share of daily volume), by the exposure you already hold in the same sector or factor, and by the correlation with existing positions. The common mistake is to size a high-conviction idea so large that a single wrong call dominates the year.

WORKED EXAMPLE: SKEW AND SIZING FOR A LONG

Marlin Components is an invented industrial supplier at 50.00. You see a bull case of 70 (35% probability), a base case of 55 (45%) and a bear case of 35 (20%). The fund is willing to lose 0.75% of capital on a single position in the bear case, and the sector already holds 6.5% of capital against a limit of 8%. How should you size it?

Answer: The expected gain is 12.5% with a reward to risk of about 3 to 1. The loss budget supports 2.5% of capital but the sector limit allows only 1.5%, so I would take 1.5% and add only if the sector room increases.

> **Interview tip:** Give the expected return, the ratio, the size from the bear case and the constraint that binds. Say which probability you are least sure of.

INT.HJ.3.b · Risk, sizing and when you are wrong

Set thesis-break rules rather than only price stops, decide when to add to a loser or cut it, when to pass on an idea, and run a pre-mortem.

Every position needs a statement of what would prove it wrong, written before the trade. A thesis-break rule names observable facts (a margin below a level, a lost customer, a delayed approval, an accounting problem) and says what you do when one occurs. A price stop alone cannot tell a falling price caused by a broken thesis from one caused by a market sell-off, so use price as a trigger for review, not as the reason to sell, and keep a harder stop for positions where the loss could grow quickly, such as shorts. When a position falls, ask whether you would buy it today at the new price, with the same sizing, knowing what you know. If the thesis is intact and the loss budget allows it, a small add can be justified; if the news hits the driver of the thesis, cut. Pass when there is no edge, no catalyst, or a better use of capital. A pre-mortem assumes the position lost 30% and asks what most likely went wrong, then turns each answer into a signpost to monitor.

WORKED EXAMPLE: THESIS RULE AGAINST A PRICE STOP

You buy Corvin Plastics, an invented packaging film maker, at 80.00 with a target of 104 and a bear value of 60. The thesis is that gross margin recovers from 29% to 32% by the third quarter as freight costs fall. Your rule: thesis broken if gross margin is below 29.5% at the second-quarter result, and the price triggers a review (not a sale) at 15% below entry, which is 68. The shares fall to 66. Compare two outcomes: margin of 30.8%, and margin of 28.9%.

Answer: In Case A the margin of 30.8% is above the 29.5% break, so the thesis is intact and the lower price improves the skew from 1.2 to 1 to about 6.3 to 1: hold, and add a little within the loss budget. In Case B the margin of 28.9% breaks the thesis, so I cut at the same price. The rule separates the two cases; a price stop would have treated them alike.

> **Interview tip:** Say that price triggers a review and the thesis decides the action, then give one example of each case with numbers.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.