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opinion

When assessing stocks, look down not up

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On the way to a barn dance earlier this year, I suffered an embarrassing accident. My wife and I had parked in a field and as we walked toward the barn, I was focused on our conversation, not on where I was stepping. Result: I blundered into a large cow patty.

Nobody danced close to me that night and for good reason. I had forgotten one of my cardinal rules: Always look down.

It applies just as much to value investing as it does to walking across a cow pasture.

Most investors focus on the upside when they buy a stock – that is, how much money they might make if things work out just right. I think the opposite approach makes more sense. Start by identifying the downside: How much money could you potentially lose?

This downward-looking approach keeps your expectations in check. It also allows you to be patient. Things rarely work out exactly as planned when you buy a stock, but if you are confident your downside is protected, you can ignore short-term ups and downs and wait for the underlying value in your investment to surface. After all, if you aren't worried about losing money, all the other outcomes are great.

How does my downward-looking approach work in practice? Consider one of my fund's newest investments: Seaport Entertainment Group Inc. (SEG-A +1.48% increase) a company that owns a clutch of real estate and entertainment assets in New York and Las Vegas. Seaport used to be a division of a publicly listed real-estate developer called Howard Hughes Holdings Inc., but Hughes decided that the unit's entertainment and hospitality focus didn't really fit with the rest of its business and spun off the enterprise in July.

Shareholders of Howard Hughes received one share of Seaport for every nine shares of Howard Hughes they held. In addition, the company announced a rights issue that gives each Seaport shareholder the right to buy additional shares directly from Seaport.

If these manoeuvres sound complicated, so they should. Both spinoffs and rights issues require a fair bit of work to analyze. Seaport is an extreme case: It is rare to get both a spinoff and a rights issue in the same security at the same time.

However, all this complexity has a bright side. Spinoffs and rights issues tend to scare off investors who don't want to be bothered mucking through the details. Right now, Seaport is a bit of an orphan and largely ignored by the market. Look at it more closely, though, and you may see the same value opportunity I do.

Seaport's largest business is the Seaport neighbourhood in Lower Manhattan. It consists of 13 restaurants, three bars, a rooftop event venue and large amounts of rentable space.

Okay, to be fair, these hospitality assets are also Seaport's problem child. Operating losses in the restaurant business and unleased space have led to recurring losses and large writedowns.

However, there are grounds for hope. As part of the spinout of Seaport, a new management team headed by MGM resorts veteran Anton Nikodemus is taking charge of operations. They should be able to bring fresh expertise to Seaport's hospitality businesses – expertise it lacked when it was operating as a small unit of a big real estate developer. They stand a good chance of turning around the business if they can turn Seaport into a destination where people stay and play instead of just stopping by for a quick meal.

Granted, a turnaround of this nature will take time. But I figure that Seaport after the rights issue is completed will have approximately US$190-million of cash. That should carry the company for a considerable time.

What happens if the turnaround doesn't happen quite as smoothly as investors would like? This is where downside protection comes into play.

In addition, to its hospitality assets, Seaport owns a one-acre development site in Lower Manhattan. It also owns a Triple-A baseball team and 10,000-person stadium in Las Vegas, as well as 80 per cent of the air rights over top of the Brookfield-owned Fashion Show Mall, also in in Las Vegas.

By my estimate, these other assets are at least equal to the Seaport's current stock market value. To be sure, valuing assets is an imprecise art, but if I'm even approximately right, Seaport shareholders are getting a large entertainment venue in Manhattan, and the possibility of a turnaround in the hospitality business, essentially for free.

The potential upside is attractive. But what really makes this situation shine for me is the limited downside. I'm a firm believer in the notion that good investors always look down before they look up. It's a principle I plan to keep in mind at my next barn dance.

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