

Profitable Curiosity

by Sandy Serva



Terry Burke combines his accounting and analytical skills to produce better returns with less volatility.

Terry Burke
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Most people cringe at even the mention of a bear market, but for Terry Burke it presented the perfect opportunity to prove that his distinctive approach to money management actually worked.

“In a bull market, everyone is a genius,” Burke says. “There was no incentive for investors to try something new and outside the mainstream. So I had to bide my time patiently until we got into a strong bear market.” When the bubble burst, people took notice that Burke’s approach was yielding results. His large-cap portfolio returned 1.2% in 2001 and was down -4.4% in 2002, while the S&P 500 lost -14.3% and -22.1% respectively, in those last two years. “With the bear market, investors came seeking better returns with less volatility. We expect to add \$25 million to our separate account management products this year.”

An accounting major, Burke started his career in 1970 working at a CPA firm. He then started his own consulting business for small public and private companies, helping them to analyze critical data to make strategic decisions about the future rather than simply preparing financial statements reflecting the past. Burke began to ponder why some companies within the same industry having the same profitability characteristics performed better than others. There had to be substantive reasons.

While curiosity might have killed the cat, it drove

Burke to uncover answers that would lead to a unique investing style, and ultimately a better money mousetrap.

“It seemed to me that while earnings were important, how management allocated those earnings was even more important,” Burke says. “Were they allocating towards growth, or were they getting more defensive? I realized that what drives the price of a stock isn’t its earnings, but its growth potential. And the question then became, ‘How do you quantify that?’ Because if you could quantify growth potential at the point of conception to reflect management’s view of the future, rather than some Wall Street analyst’s view — then you’d have something.”

Knowing that Wall Street tended to make assumptions about growth based on internal and external factors, Burke began to dig deeper — dissecting a company’s balance sheet. “I spent four years in a trial-and-error mode looking for the link between balance sheet items and earnings. I found 26 items in the balance sheet that have predictive qualities — some stronger than others.” Burke then combined them into a series of formulas and weighted them according to their influence on growth. He called the result the Q.E.P. Index; the Q.E.P. stands for Quantitative Earnings Power. “I found that in 80% of the cases, a change in the index trend signaled a change in growth potential, and ultimately, price,” he says. “And the market is slow to react, usually taking three days to three weeks to build a consensus on the new value, which gives us an opportunity to capture the growth premium before the market can price it in or out.”

Burke started using this quantitative/qualitative approach in 1992 and has found that it works well in both up and down markets. The goal is to shoot for high returns and low volatility — music to any investor’s ears. “Another advantage is when fewer stocks are showing growth potential, the markets eventually turn down as the growth premium begins to be priced out. Therefore, we manage portfolios by defaulting to cash when fewer stocks are available. Fewer stocks means less growth potential, and ultimately, a weaker economy which is what a declining market is signaling.” The result is a return greater than the market’s performance with a standard deviation that is much less. ✦

BURKE VS. S&P

	1-Yr.	3-Yr.	5-Yr.
Large Cap	-4.4%	7.3%	17.5%
S&P 500	-22.1%	-15.7%	-1.9%