Chapter 16 (book – 14)

Rechecking the story

The Practice of Periodic Review
Check quarterly earnings, financial reports, and business fundamentals every few months to ensure companies perform as expected.

The Three Phases of Growth
Phase One: Start-Up Phase

The company proves its business model works. It's working out operational kinks and building initial customer relationships. Why it's risky: Many startups fail; there's no guarantee the model will scale.

Phase Two: Rapid Expansion Phase

The proven model is simply duplicated across new markets. McDonald's opens franchises in new cities. Sears expands to new regions. Why it's safest and most profitable: The business model is already validated. Management knows what works. Each expansion is predictable execution.

Phase Three: Mature/Saturation Phase

The company runs out of new markets. Every major city has a McDonald's. Every top mall has The Limited. Why it's problematic: Easy growth ends. The company must innovate, acquire competitors, or accept slower growth. Stock valuations typically compress.

The Key Insight
Track whether your companies are moving between phases. Companies still in phase two (like Automatic Data Processing) have significant growth runway and represent the best investment opportunities.

The Saturation Problem
When Sears saturated every major city, The Limited filled 670 of 700 top malls, and Wendy's faced McDonald's on every corner, these companies hit a wall. Growth by geographic expansion ended. The Limited's acquisitions (Lerner, Lane Bryant) signaled management didn't know what to do next—a red flag that fast growth was over.

The Critical Difference: Innovation vs. Stagnation

McDonald's solved saturation through product innovation: drive-through windows, breakfast service, salads, and chicken. These kept earnings strong even as the p/e ratio compressed from 30 to 12. Cable companies found sequential growth spurts: rural installations, then pay services, then urban areas, then advertising. The story kept improving.

A Cautionary Tale: Texas Air

This section warns against following the *story* instead of the *fundamentals*.

Texas Air is an example of a story that got worse, then better, then worse again in a matter of five years. I took a small position in the stock in mid-1983, only to watch the company's principal asset, Continental Air, deteriorate and file for Chapter 11. Texas Air stock fell from $12 to $4¾, and Continental stock, in which Texas Air held the majority position, fell to $3. I kept a close eye on the situation as a potential turnaround. Texas Air cut costs; Continental won back its customers and returned from the accountant's graveyard. On the strength of their improvement, I built up a large holding in both companies. By 1986 both stocks had tripled. In February, 1986, Texas Air announced it had purchased a large share of Eastern Airlines—also viewed as a favorable development. In a single year Texas Air stock tripled once again to a high of $51½, making it a tenbagger since it solved its problems in 1983.

The Texas Air Story: Why Peter Got Blindsided

The Fatal Mistake (1986-1987)

Texas Air then acquired Eastern Airlines with the same playbook: cut costs, restore profits. The stock tripled again to $51.50—a tenbagger. Lynch should have exited but instead bought more shares at $48.25 in February 1987.

Why? He was seduced by the *improved story*: leaner operations, reduced labor costs, acquiring Frontier and People's Express, and analyst predictions of $15 per share earnings by 1988.

The Problem: He Ignored Reality

Every day brought warning signs that Lynch dismissed:

- Lost bags, botched schedules, delayed arrivals
- Angry customers and disgruntled employees

- Bitter labor disputes between management and unions

Lynch focused on predicted earnings while ignoring that the fundamentals were falling apart. An airline's reputation (built over decades) can collapse in months with poor service. Eastern was having "more than a few bad nights."

The Collapse

Earnings deteriorated in early 1987. Lynch finally sold at $17-18; the stock fell to $9 by year-end. He'd turned a tenbagger into mediocre returns.

The Missed Opportunity

Delta Airlines—Eastern's main competitor—was the real beneficiary, stealing customers as Eastern collapsed. Lynch had a modest Delta position but should have made it a top holding instead of staying committed to failing Texas Air.

The Lesson: He followed the story instead of the facts, ignored operational warning signs, and confused potential earnings with probable execution.

The Lesson
Even successful investors get blindsided when they focus on potential earnings rather than current reality. The author should have sold Texas Air and bought Delta (the beneficiary of Eastern's problems) instead.

Discussion : Can you identify a company in today's market that's either innovating through saturation, or telling a great story with deteriorating fundamentals?