VALUE INVESTING I: SETTING THE TABLE

The Lead In
Value Investing: The Winner?

- One of the classes that I teach is on investment philosophies, where I begin by describing an investment philosophy as a set of beliefs about how markets work (and sometimes don't) which lead to investment strategies designed to take advantage of market mistakes.

- Unlike some, I don't believe that there is a single "best" philosophy, since the best investment philosophy for you is the one that best fits you as a person. I start with technical analysis and charting, move on to value investing, then on to growth investing, and end with information trading and arbitrage.

- The most common pushback that I get is from old-time value investors, arguing that there is no debate, since value investing is the only guaranteed way of winning over the long term.
Three Questions

- What is value investing and what do you need to do to be called a value investor?
  - There is no consensus even among value investors, other than that value investing is buying cheap companies.
  - Within value investing, there are multiple strands, with very different views of how markets work (or do not).
- Where does this certitude that value investing is the "winningest" philosophy come from? Is it deserved?
- How long is the long term, and is it guaranteed that value investing wins?
What is value investing?

- **Lazy Value Investing**: Let's start with the easiest and most simplistic definition, and the one that many data services and academics continue to use, simply because it is quantifiable and convenient, and that is to base whether you are a value or growth investor on whether the stocks you buy trade at low or high multiples of earnings or book value.

- **Cerebral Value Investing**: Good value investing starts by looking at cheapness (PE and PBV) but also includes other criteria such as good management, solid moats or competitive advantages and other qualitative factors.

- **Big Data Value Investing**: Closely related to cerebral value investing in philosophy, investors start with the conventional measures of cheapness (low PE and low PBV) but also look for additional criteria that has separated good investments from bad ones. Those criteria are found by poring over the data and looking at historical returns, a path made more accessible by access to huge databases and powerful statistical tools.
A different categorization

- **Passive Value Investing:** In passive value investing, you screen for the best stocks using criteria that you believe will improve your odds. Once you buy these stocks, you are asked to be patient, and in some cases, to just buy and hold, and that your patience will pay off as higher returns and a more solid portfolio.

- **Contrarian Value Investing:** In contrarian value investing, you focus your investing energies on companies that have seen steep drops in stock prices, with the belief that markets tend to overreact to news, and that corrections will occur, to deliver higher returns, across the portfolio.

- **Activist Value Investing:** In activist value investing, you target companies that are not only cheap but badly run, and then expend resources (and you need a considerable amount of those) to push for change, either in management practices or in personnel. The payoff to activist value investing comes from activist investors being the catalysts for both price change in the near term, as markets react to their appearance, and to changes in how the company is run, in the long term.

- **Minimalist Value Investing:** We have seen the rise of titled index funds and ETFs, where you start with an index fund or ETF, and tilt the fund/ETF by overweighting value stocks (high PE/PBV, for instance) and underweighting non-value stocks.
A Financial Balance Sheet Perspective

Value versus Growth Investing: A Financial Balance Sheet Perspective

In value investing, your focus on finding bargains and misvalued companies is in assets in place, where you believe that you have the data to estimate value more precisely and markets can get the pricing of assets in place wrong.

- **Assets**
  - Expected Value of investments already made
  - Expected Value Added (or Destroyed) by future investments

- **Liabilities**
  - **Assets in Place**
    - Debt
      - Borrowed money
  - **Growth Assets**
    - Equity
      - Owner's funds

In growth investing, your focus on finding bargains and misvalued companies is in growth assets, where you believe that while you will face more uncertainty and imprecision in estimating value, that same uncertainty will lead markets to price growth assets wrong.
When stock markets were in their infancy, investors faced two problems.

- The first was that there were almost no information disclosure requirements, and investors had to work with whatever information they had on companies, or on rumors and stories.
- The second was that investors, more used to pricing bonds than stocks, drew on bond pricing methods to evaluate stocks, giving rise to the practice of paying dividends (as replacements for coupons).

Ben Graham laid the foundations for modern value investing, by formulating his approach to buying stocks and investing in 1934 in Security Analysis, a book that reflected his definition of an investment as "one which thorough analysis, promises safety of principal and adequate return". Graham's subsequently wrote The Intelligent Investor, where he elaborated his more developed philosophy of value investing and developed a list of screens, built around observable values, for finding under valued stocks.

In 1938, John Burr Williams wrote The Theory of Investment Value, introducing the notion of present value and discounted cash flow valuation.
Buffett, one of Graham’s students at Columbia University, started an investment partnership, putting value investing into practice, with his own unique twists for his partners.

He dissolved that partnership (famously) in 1969, arguing that given a choice between bending his investment philosophy and finding investments and not investing, he would choose the latter.

These words, in his final letter to partners in May 1969, more than any others have cemented his status in value investing: "I just don't see anything available that gives any reasonable hope of delivering such a good year and I have no desire to grope around, hoping to "get lucky" with other people's money.

He did allow his partners a chance to receive shares in a struggling textile maker, Berkshire Hathaway, and the rest, as they say, is history, as Berkshire Hathaway morphed into an insurance company, with an embedded closed end mutual fund, investing in both public and some private businesses, run by Buffett.
And the Berkshire Hathaway payoff

<table>
<thead>
<tr>
<th></th>
<th>Berkshire Hathaway</th>
<th>S&amp;P 500</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Compounded Annual Return</strong></td>
<td>19.95%</td>
<td>9.95%</td>
</tr>
<tr>
<td><strong>Cumulated Value of $100 invested in 1965, with dividends reinvested in S&amp;P</strong></td>
<td>$2,533,062.56</td>
<td>$19,812.75</td>
</tr>
</tbody>
</table>

**Berkshire Hathaway: The History (1965-Sept 2020)**

- Buffett acquired control of Berkshire Hathaway in 1995
- Berkshire takes controlling interest in GEICO in 1976
- Berkshire acquires rest of GEICO in 1996 for $2.3 billion
If all that value investing had for it were the stories of great value investors and their exploits, it would not have the punch that it does today, *without the help of a numbers strand, ironically driven by the very academics* that value investors hold in low esteem.

The capital asset pricing model, despised by value investors, also was developed in 1964, and for much of the next 15 years, financial researchers worked hard trying to test the model. To their disappointment, the model not only revealed clear weaknesses, but it consistently misestimated returns for classes of stock.

- In 1981, Rolf Banz published a paper, showing that *smaller companies (in terms of market capitalization) delivered much higher returns*, after adjusting for risk with the CAPM, than larger companies.

- Over the rest of the 1980s, researchers continued to find other company characteristics that seemed to be systematically related to returns, even though theory suggested that they should not.
The Fama-French Effect

Between 1927 and 2020, the stocks with the lowest price to book ratios earned 5.22% more per year than stocks with the highest price to book ratios.
With different interpretations..

- **It is a proxy for missed risk**: In their 1992 paper, Fama and French argued that companies that trade at low price to book ratios are more likely to be distressed and that our risk and return models were not doing an adequate job of capturing that risk. They and others who have advanced the same type of argument would argue that rather than be a stamp of approval for value investing, these studies indicate risks that may not show up in near term returns or in traditional risk and return models but eventually will manifest themselves and cleanse the excess returns. Put simply, in their world, value investors will look like they are beating the market, until these unseen risks show up and mark down their portfolios.

- **It is a sign of market inefficiency**: During the 1980s, as behavioral finance became more popular, academics also became more willing to accept and even welcome the notion that markets make systematic mistakes and that investors less susceptible to these behavioral quirks could take advantage of these mistakes. For these researchers, the findings that low price to book stocks were being priced to earn higher returns gave rise to theories of how investor irrationalities could explain these returns.
The End Result

- When valuing companies, I talk about how value is a bridge between stories and numbers, and how the very best and most valuable companies represent an uncommon mix of strong stories backed up by strong numbers.

- In the realm of investment philosophies, value investing has had that unique mix work in its favor, with stories of value investors and their winning stocks backed up by numbers on how well value investing does, relative to other philosophies.

- It is therefore no surprise that many investors, when asked to describe their investment philosophies, describe themselves as value investors, more because it has been historically viewed as not just a winning philosophy, but one with intellectual and academic backing for its successes than due to any loyalty or adherence to its core principles.