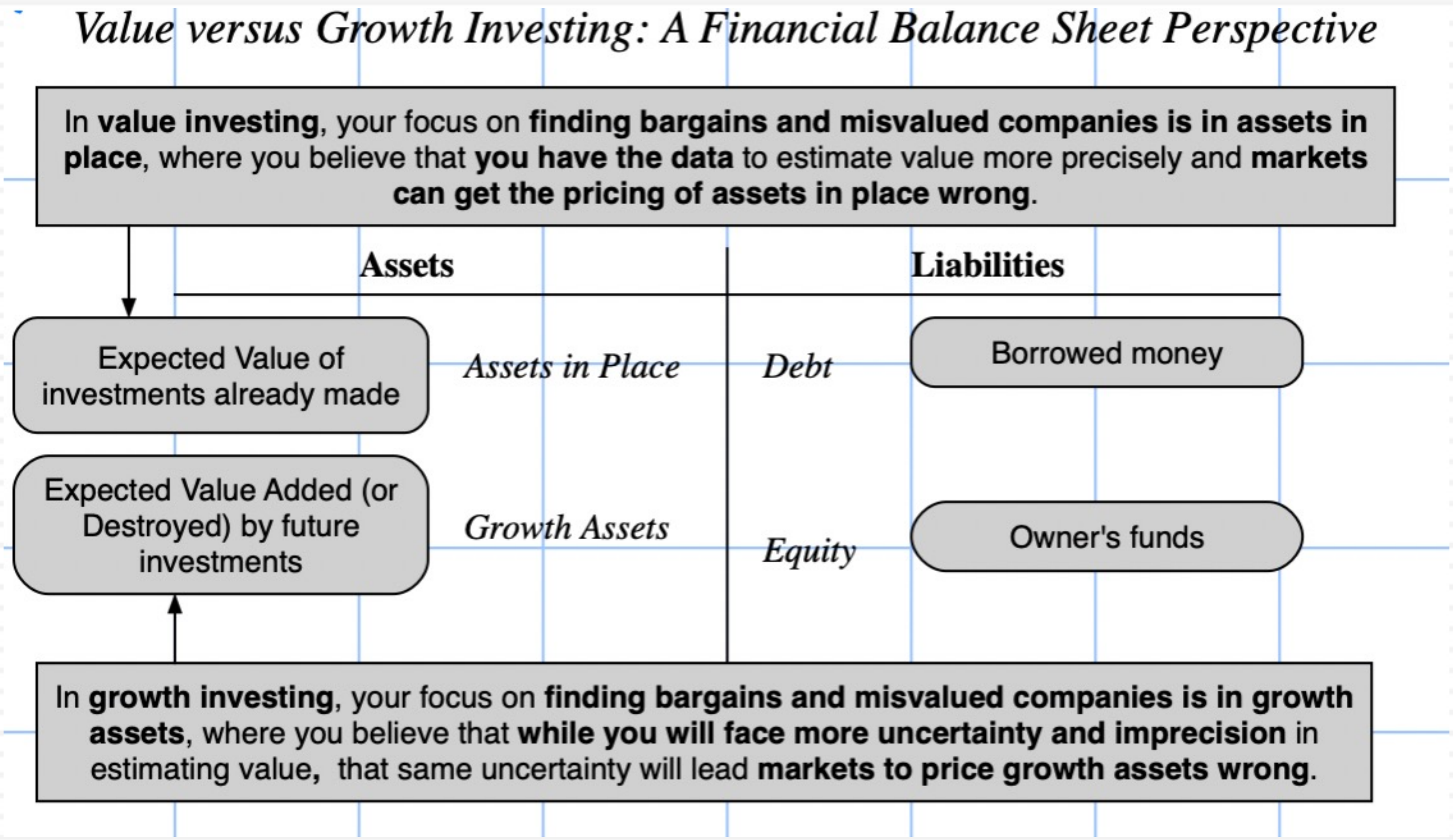
WHERE IS THE "VALUE" IN VALUE INVESTING?

Aswath Damodaran

Who is a value investor?



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.

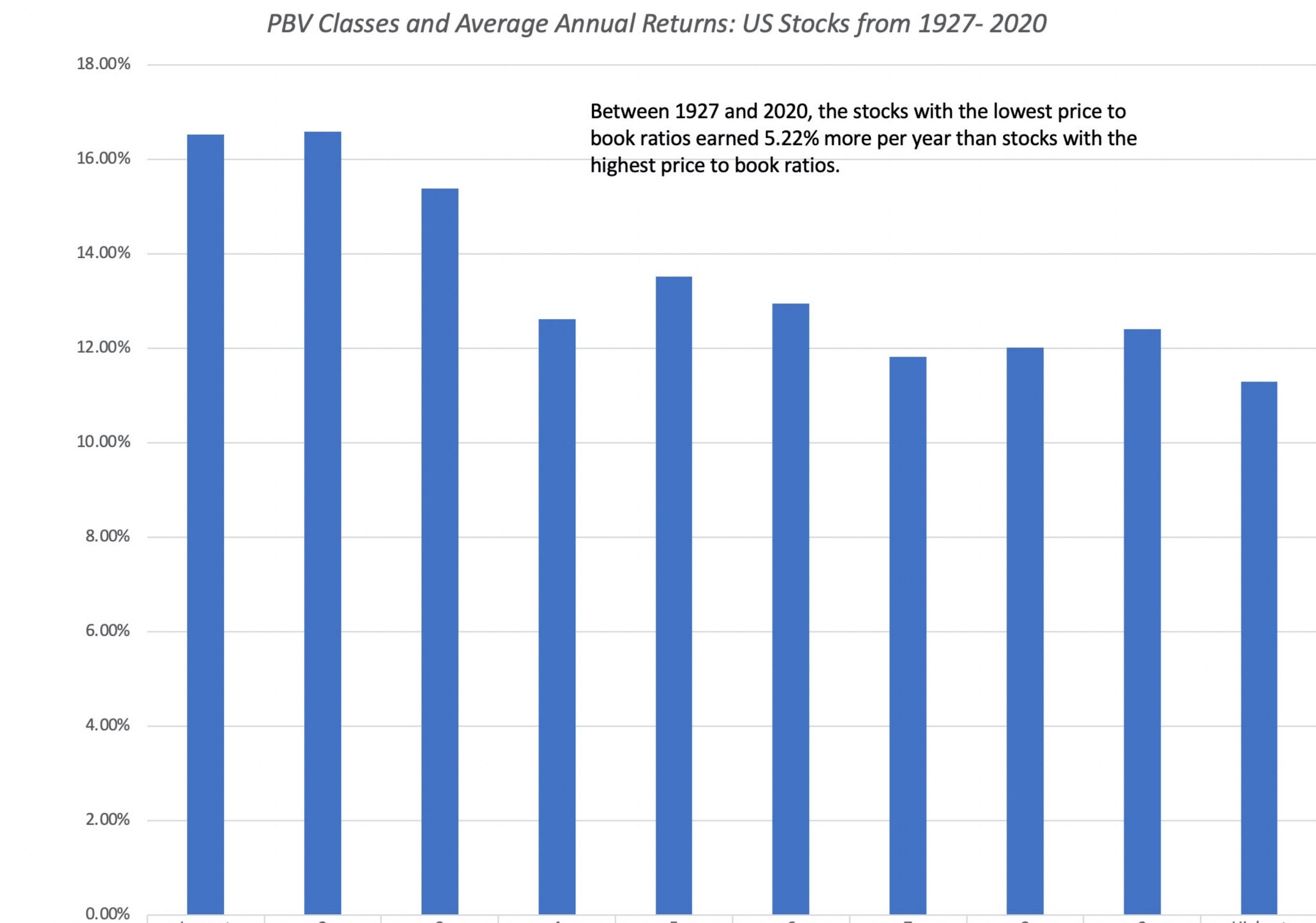
In its many forms…

- 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.

The Case for Value Investing: The Story Roots

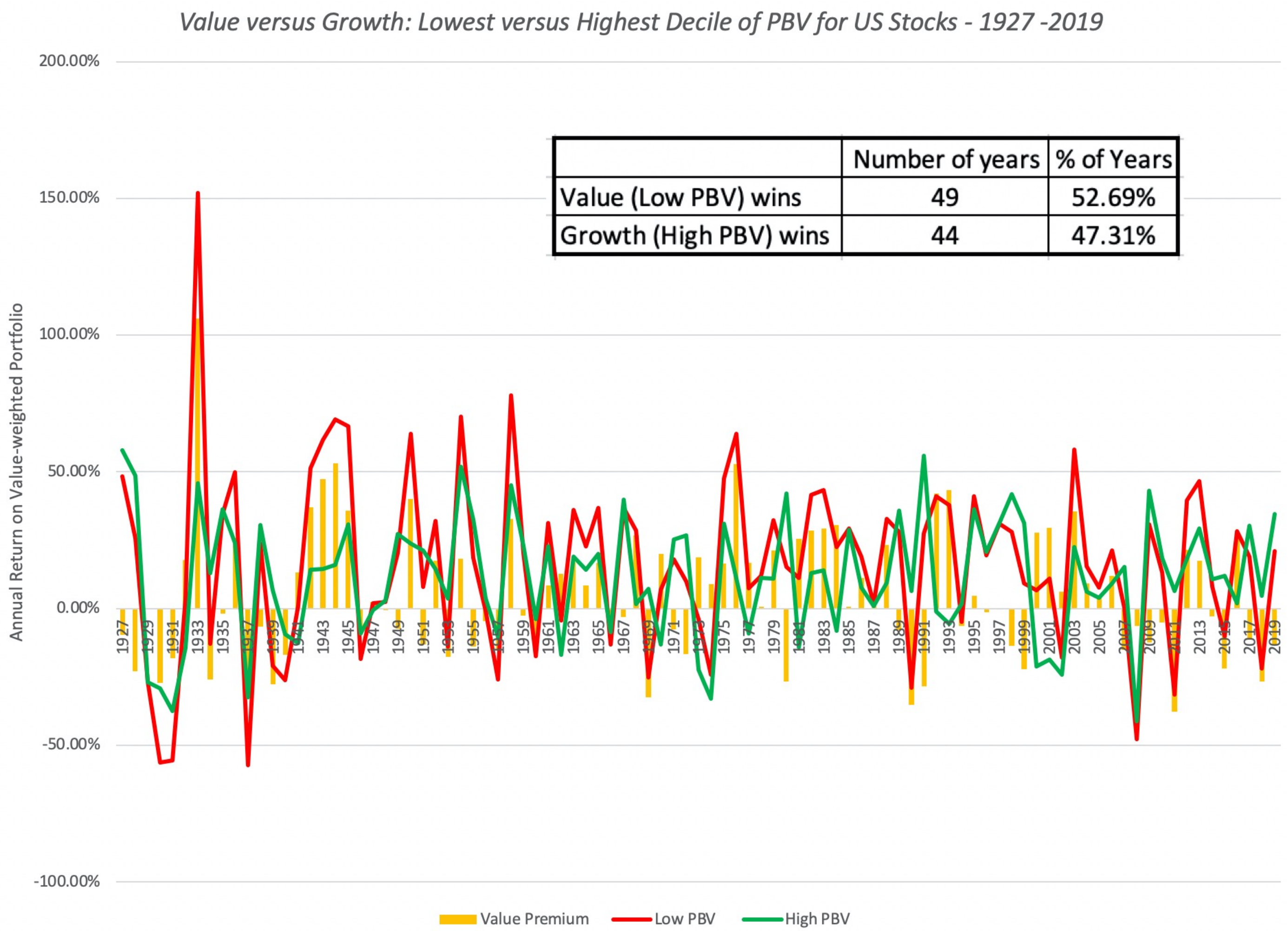
- Ben Graham laid the foundations for modern value investing, by formalizing his approach to buying stocks and investing in 1934 in *Security Analysis*, a book that reflected his definition of an investment as "one which thorough analysis, promises safety of principal and adequate return".
- Buffett, 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.

The Case for Value Investing: The numbers side..



	Lowest	2	3	4	5	6	7	8	9	Highest
Average Return	16.51%	16.58%	15.37%	12.61%	13.52%	12.95%	11.82%	12.01%	12.40%	11.29%

Even those glory days were not that glorious…



	Number of years	% of Years
Value (Low PBV) wins	49	52.69%
Growth (High PBV) wins	44	47.31%

And active value investing does not seem to have a payoff…

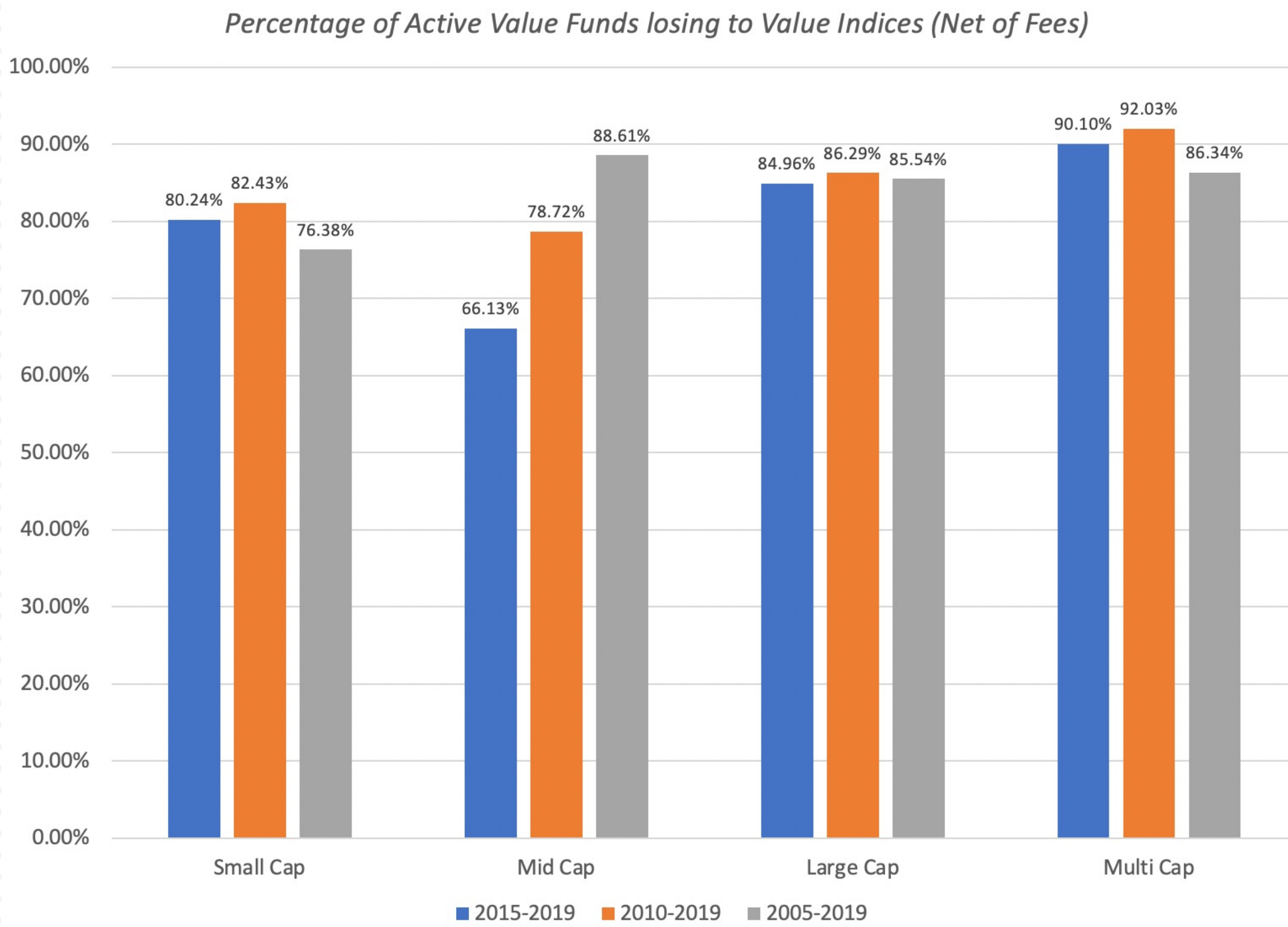
- No excess returns? While the earliest studies of mutual funds looked at them as a group, and concluded that they collectively under performed the market, later studies have looked at mutual funds, grouped by category (small cap vs large cap, value vs growth) to see if fund managers in any of these groupings performed better than managers in other groupings.
  - *None of these studies have found any evidence that value fund managers are more likely to beat their index counterparts than their growth fund counterparts.*
- The Warren Buffett Card: It is telling that value investors, when asked to defend its capacity to add value to investing, almost never reference the research, partly because there is little that they can point to as supportive evidence, but instead fall back on Warren Buffett, as justification.
  - *There is no doubt about Buffett's success over the decades, but as the man turned ninety last year, it is worth asking whether the continued use of his name is more a sign of weakness in value investing, rather than strength.*

Value Investing: The Lost Decade

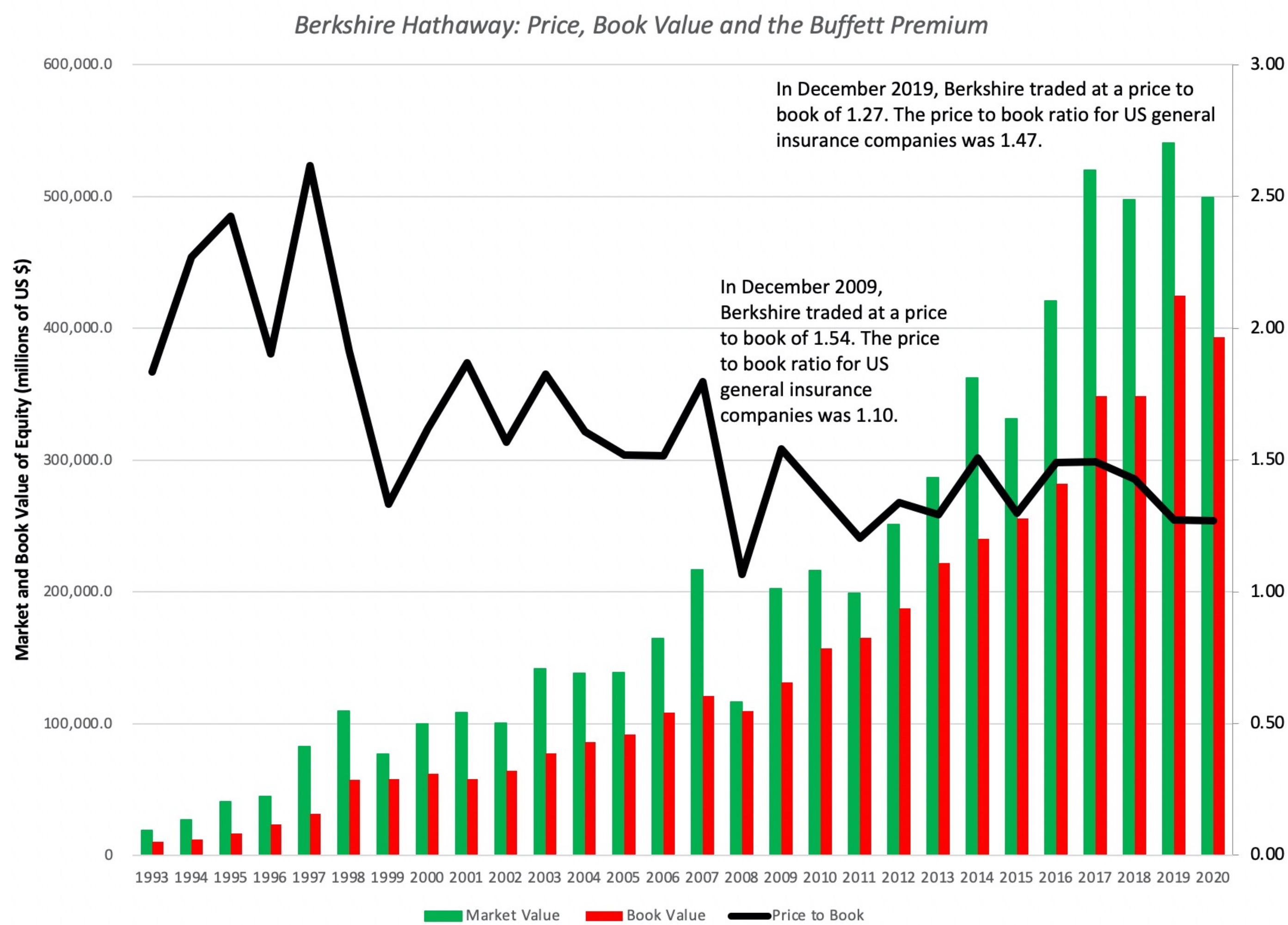
Value vs Growth: US Stocks, by decade

	Lowest PBV	*Highest PBV*	*Difference*	*Lowest PE*	*Highest PE*	*Difference*
1930-39	6.04%	4.27%	1.77%	NA	NA	NA
1940-49	22.96%	7.43%	15.53%	NA	NA	NA
1950-59	25.06%	20.92%	4.14%	34.33%	19.16%	15.17%
1960-69	13.23%	9.57%	3.66%	15.27%	9.79%	5.48%
1970-79	17.05%	3.89%	13.16%	14.83%	2.28%	12.54%
1980-89	24.48%	12.94%	11.54%	18.38%	14.46%	3.92%
1990-99	20.17%	21.88%	-1.71%	21.61%	22.03%	-0.41%
2000-09	8.59%	-0.49%	9.08%	13.84%	0.61%	13.23%
2010-19	**11.27%**	**16.67%**	**-5.39%**	**11.35%**	**17.09%**	**-5.75%**

Active Value Investing in the lost decade



Even the legends of value investing lagged…



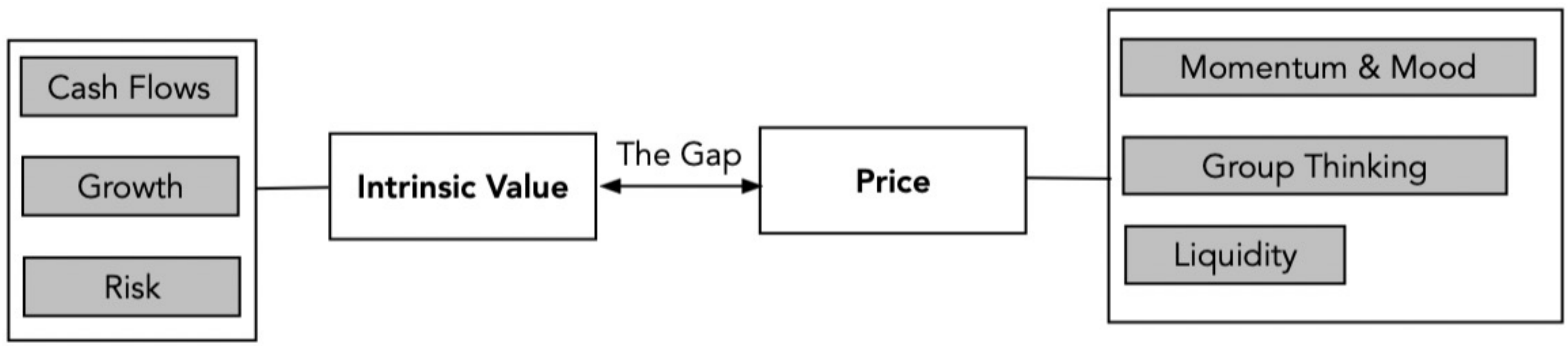
Explanations: From most benign to most consequential

- *This is a passing phase!*
  - Diagnosis: There were extended periods (like the 1990s) when low PE and low PBV stocks underperformed.
  - Prescription: Be patient. With time, value investing will deliver superior returns.
- *The Fed did it!*
  - Diagnosis: Central banks have kept rates artificially low and skewed the investment process..
  - Prescription: Central banks cannot keep interest rates low in perpetuity.
- *The Investment World has become flatter!*
  - Diagnosis: As data has become easier to get, accounting more standardized and analytical tools more accessible, there is very little competitive advantage to computing ratios from financial statements.
  - Prescription: Value investors have to become creative and go beyond publicly accessible data.
- *The global economy has changed!*
  - Diagnosis: The shift in economic power to more globalized companies, built on technology and immense user platforms, has made many old-time value investing rostrums useless.
  - Prescription: Value investing has to adapt to the new economy, with less of a balance sheet focus.

Value Investing has lost its way!

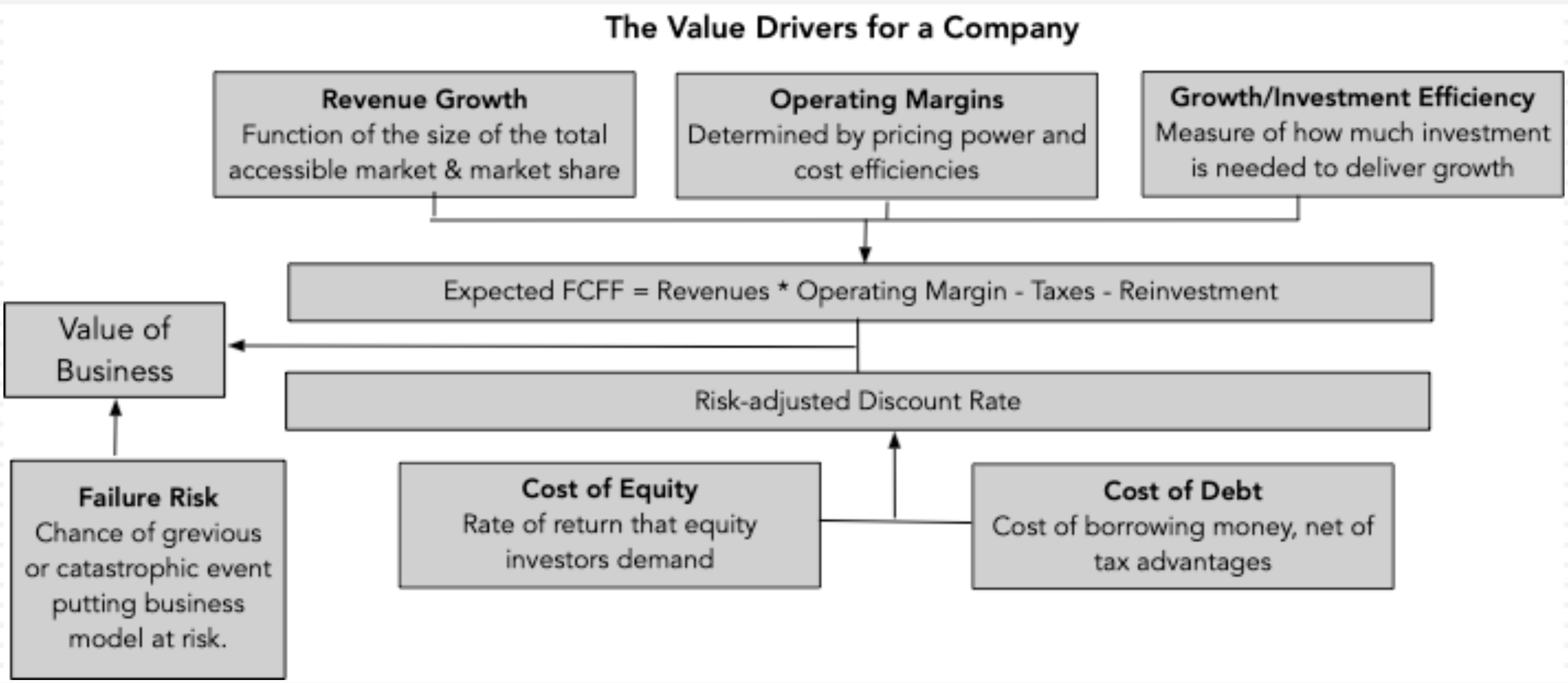
- <u>It has become rigid</u>: In the decades since Ben Graham published Security Analysis, value investing rules reflect value investing history and some are a throwback in time, and some just seem curmudgeonly. For instance,
  - Value investing has been steadfast in its view that companies that do not have significant tangible assets, relative to their market value, and that view has kept many value investors out of technology stocks for most of the last three decades.
  - Value investing's focus on dividends has caused adherents to concentrate their holdings in utilities, financial service companies and older consumer product companies, as younger companies have shifted away to returning cash in buybacks.
- <u>It is ritualistic</u>: The rituals of value investing are well established, from the annual trek to Omaha, to the claim that your investment education is incomplete unless you have read Ben Graham's Intelligent Investor and Security Analysis to an almost unquestioning belief that anything said by Warren Buffett or Charlie Munger has to be right.
- <u>And righteous</u>: While investors of all stripes believe that their "investing ways" will yield payoffs, some value investors seem to feel entitled to high returns because they have followed all of the rules and rituals. In fact, they view investors who deviate from the script as shallow speculators, but are convinced that they will fail in the "long term".

1. Be clearer about value vs price..

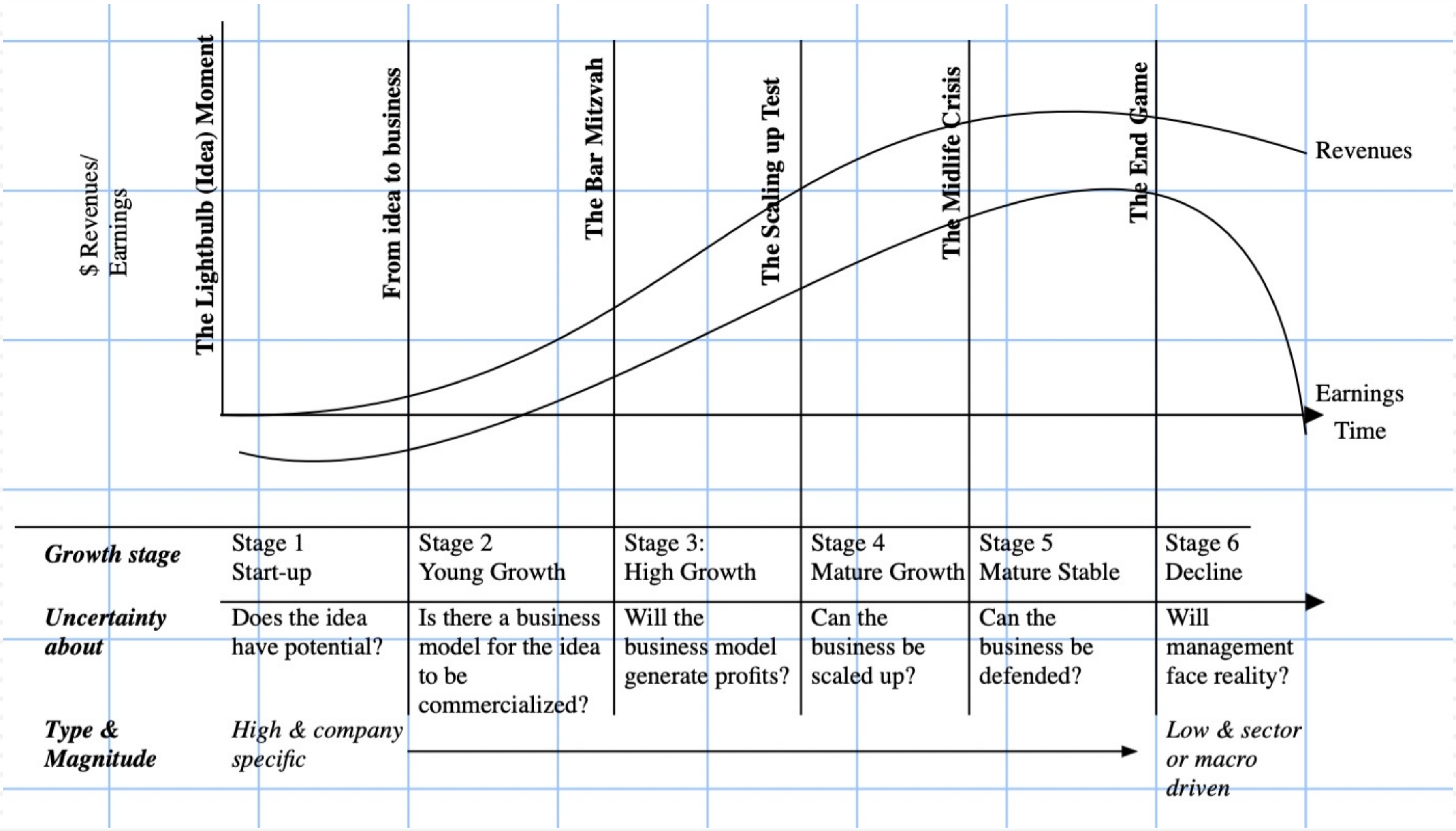


- Value is a function of cash flows, growth and risk, and any intrinsic valuation model that does not explicitly forecast cash flows or adjust for risk is lacking core elements.
- Price is determined by demand and supply, and moved by mood and momentum, and you price an asset by looking at how the market is pricing comparable or similar assets.
- Many value investors seem to view discounted cash flow valuation as a speculative exercise, and instead pin their analysis on comparing comparing on pricing multiples (PE, Price to book etc.).

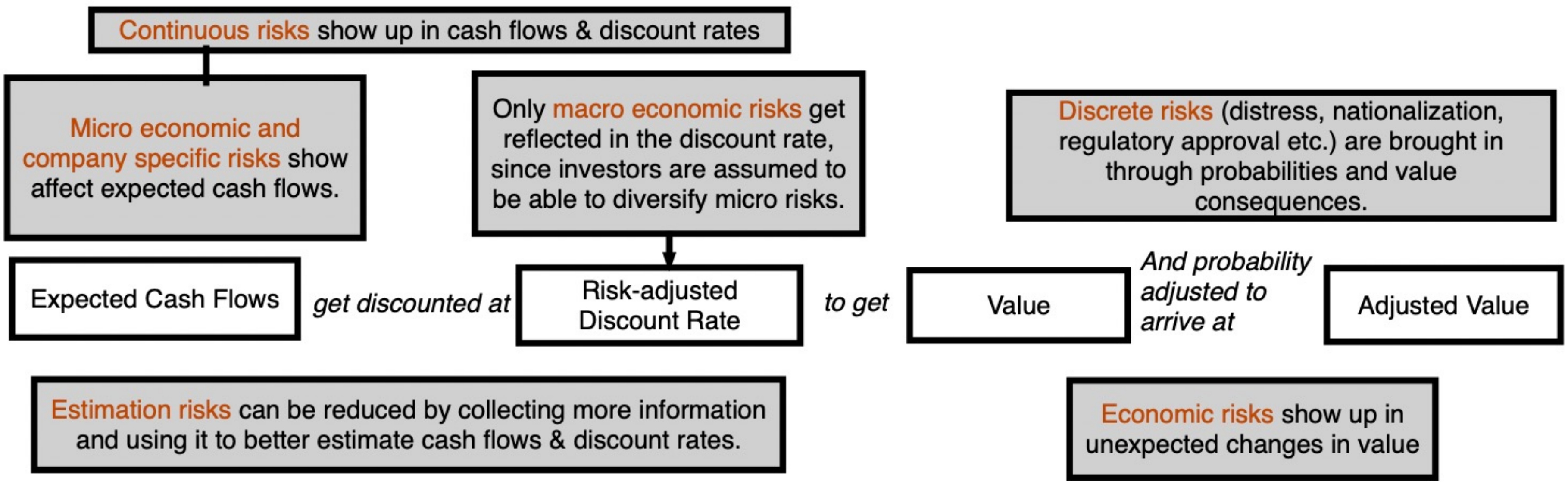
Value Drivers…



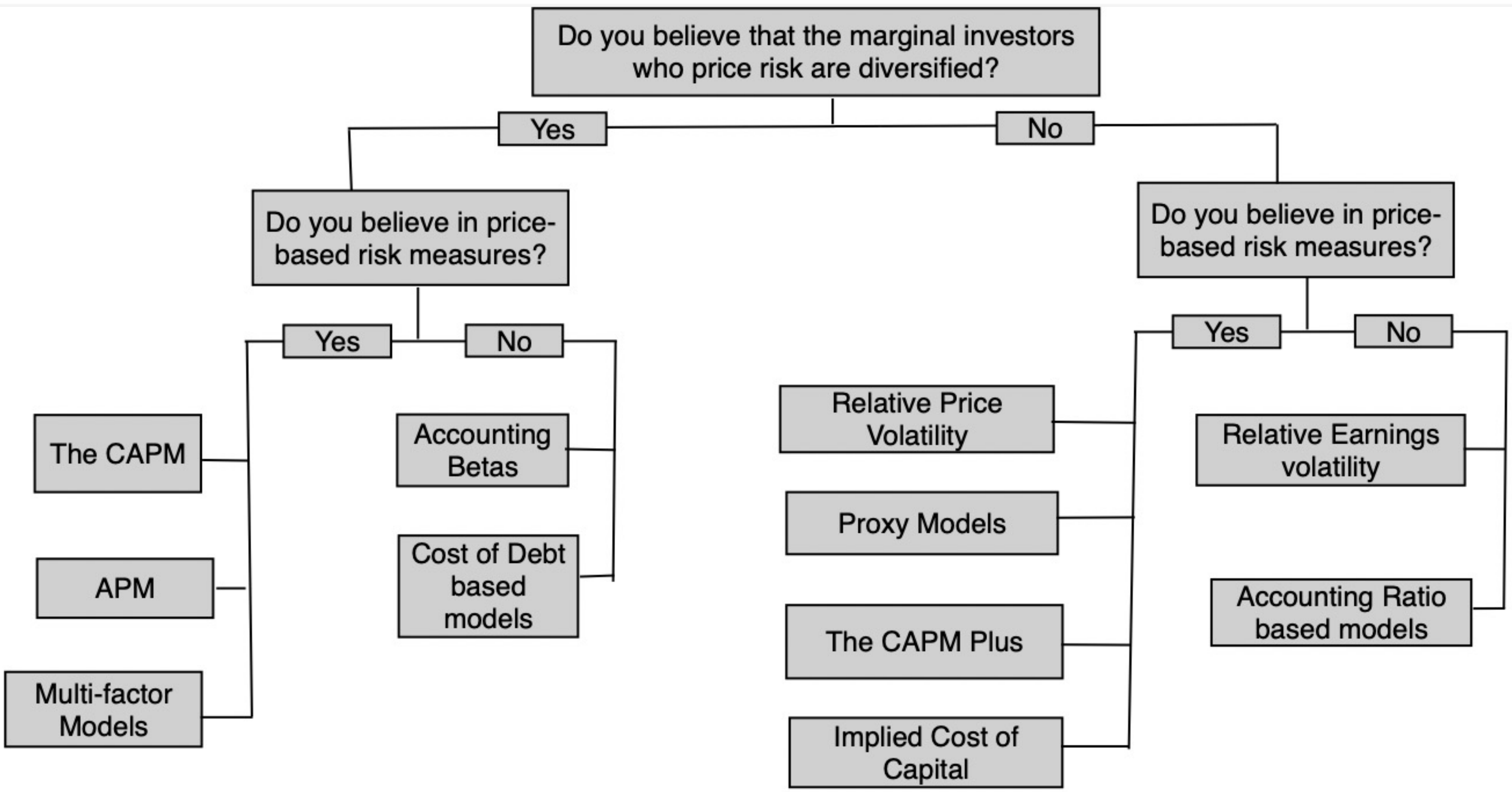
2. Avoiding uncertainty cannot be the end game…



Build uncertainty into your valuations…



3. The Margin of Safety is not a substitute for risk assessment…



And increasing MOS creates a trade off…

		The Truth	
		Stock is under valued	*Stock is over valued*
Your Analysis	*Stock is under valued*	A Good Buy	Type 1 investment error: Buy the wrong stock or fail to sell the right stock.
	Stock is over valued	Type 2 investment error: Fail to buy the right stock or sell the wrong one.	A Good Sell

Reduces the chance of type 1 error

Increases the likelihood of type 2 error

Higher Margin of Safety

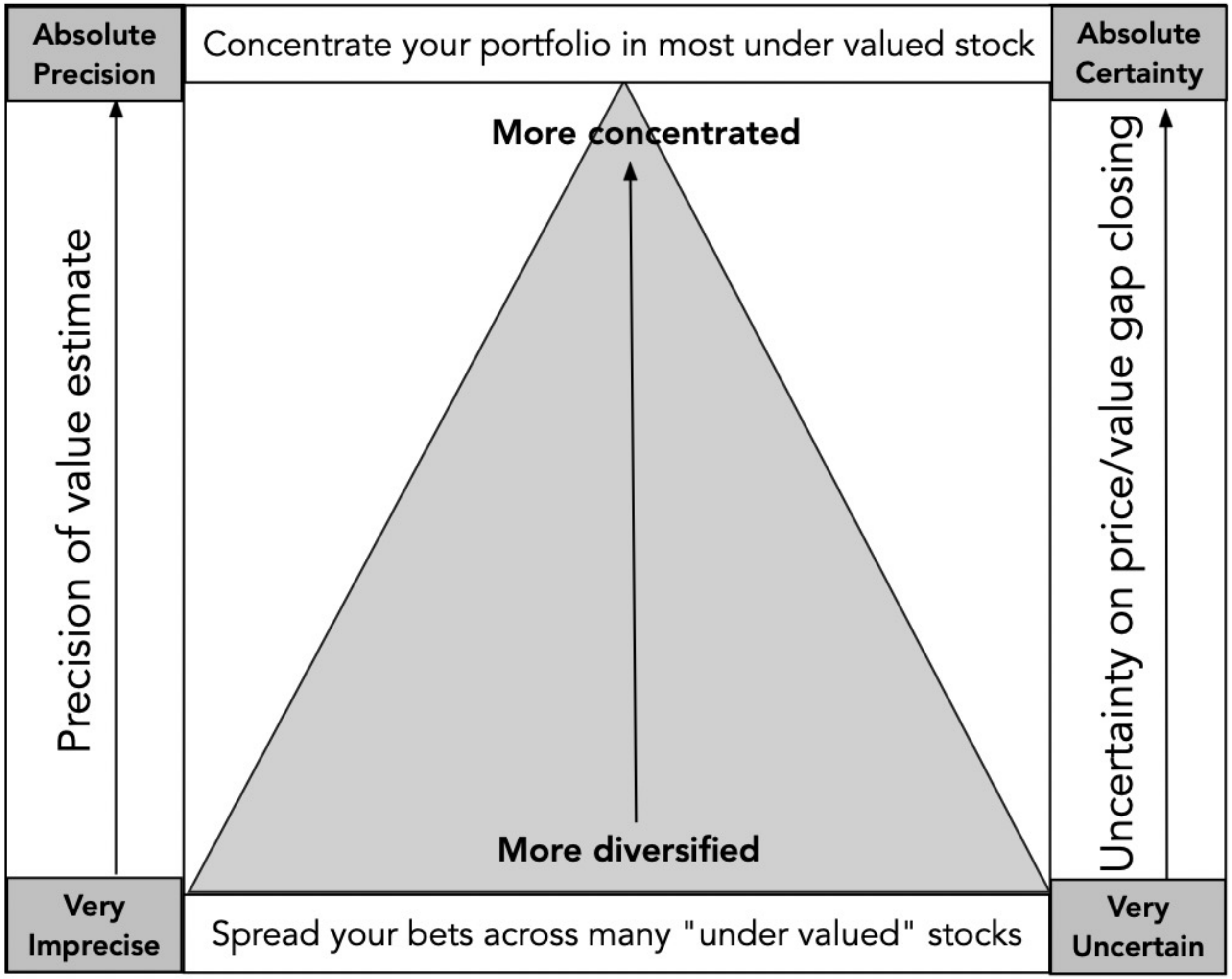
4. Don’t take accounting at face value… Or look to accounting rules for salvation..

- It is undeniable that value investing has an accounting focus, with earnings and book value playing a central role in investing strategies.
- There is good reason to trust those numbers less now than in decades past, for a few reasons.
  - One is that companies have become much more aggressive in playing accounting games, using pro forma income statements to skew the numbers in their favor.
  - The second is that as the center of gravity in the economy has shifted away from manufacturing companies to technology and service companies, accounting has struggled to keep up. In fact, it is clear that the accounting treatment of R&D has resulted in the understatement of book values of technology and pharmaceutical companies.

5. You can pick stocks and be diversified… At the same time…

- While not all value investors make this contention, a surprisingly large number seem to view concentrated portfolios as a hallmark of good value investing, arguing that spreading your bets across too many stocks will dilute your upside.
- The choice of whether you want to pick good stocks or whether you want to be diversified is a false one, since there is no reason you cannot do both.
- After all, you have thousands of publicly traded stocks to pick from, and all that diversification requires is that rather than put your money in the very best stock or the five best stocks, you should hold the best thirty or forty stocks.

Concentration vs Diversification



6. Don't' feel entitled to a reward for your virtue…

- Investing is not a morality play, and there are no virtuous ways of making money. The distinction between investing and speculating is not only a fine one, but very much in the eyes of the beholder.
  - To hold any investing philosophy as better than the rest is a sign of hubris and an invitation for markets to take you down.
  - Keeping an open mind about other investment philosophies can not only keep you grounded but allow you to incorporate aspects of those philosophies into your own.
- If you are a value investor, that is your choice, but it should not preclude you from treating other investors with respect and borrowing tools to enhance your returns.