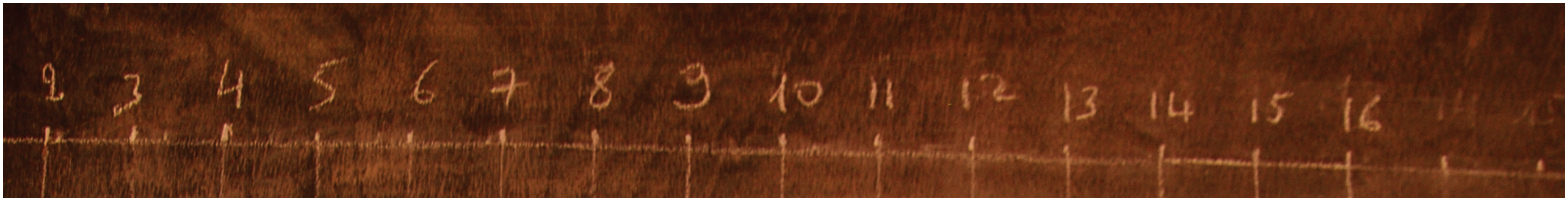


Investing for grown ups? Value Investing

Aswath Damodaran

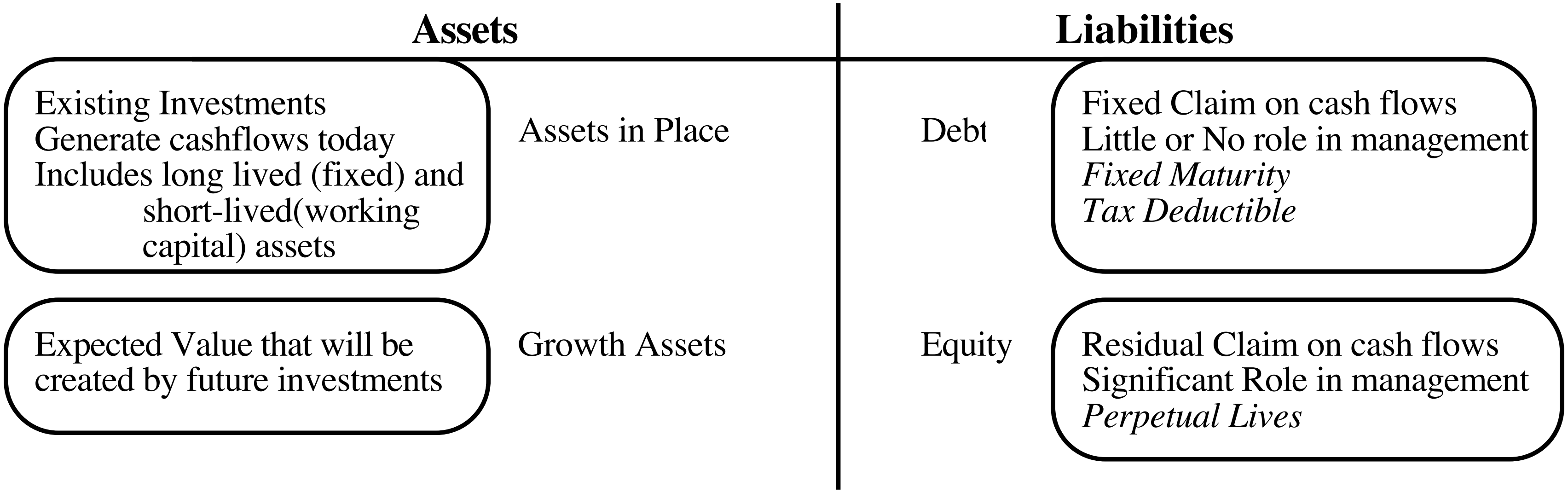
WILEY

Who is a value investor?

- The simplistic definition: The lazy definition (used by services to classify investors into growth and value investors) is that anyone who invests in low PE stocks is a value investor.
- The too broad definition: Another widely used definition of value investors suggests that they are investors interested in buying stocks for less that what they are worth. But that is too broad a definition since you could potentially categorize most active investors as value investors on this basis. After all, growth investors also want to buy stocks for less than what they are worth.

My definition…

If you are a value investor, you make your investment judgments, based upon the value of assets in place and consider growth assets to be speculative and inherently an unreliable basis for investing. Put bluntly, if you are a value investor, you want to buy a business only if it trades at less than the value of the assets in place and view growth, if it happens, as icing on the cake.



Assets

Liabilities

Existing Investments
Generate cashflows today
Includes long lived (fixed) and short-lived(working capital) assets

Assets in Place

Debt

Fixed Claim on cash flows
Little or No role in management
Fixed Maturity
Tax Deductible

Expected Value that will be created by future investments

Growth Assets

Equity

Residual Claim on cash flows
Significant Role in management
Perpetual Lives

The Different Faces of Value Investing

- Passive Screeners: Following in the Ben Graham tradition, you screen for stocks that have characteristics that you believe identify under valued stocks. You are hoping to find market mistakes through the screens.
- Contrarian Investors: These are investors who invest in companies that others have given up on, either because they have done badly in the past or because their future prospects look bleak. You are implicitly assuming that markets over react.
- Activist Value Investors: These are investors who invest in poorly managed and poorly run firms but then try to change the way the companies are run. Y

The father of value investing: Ben Graham’ s Screens

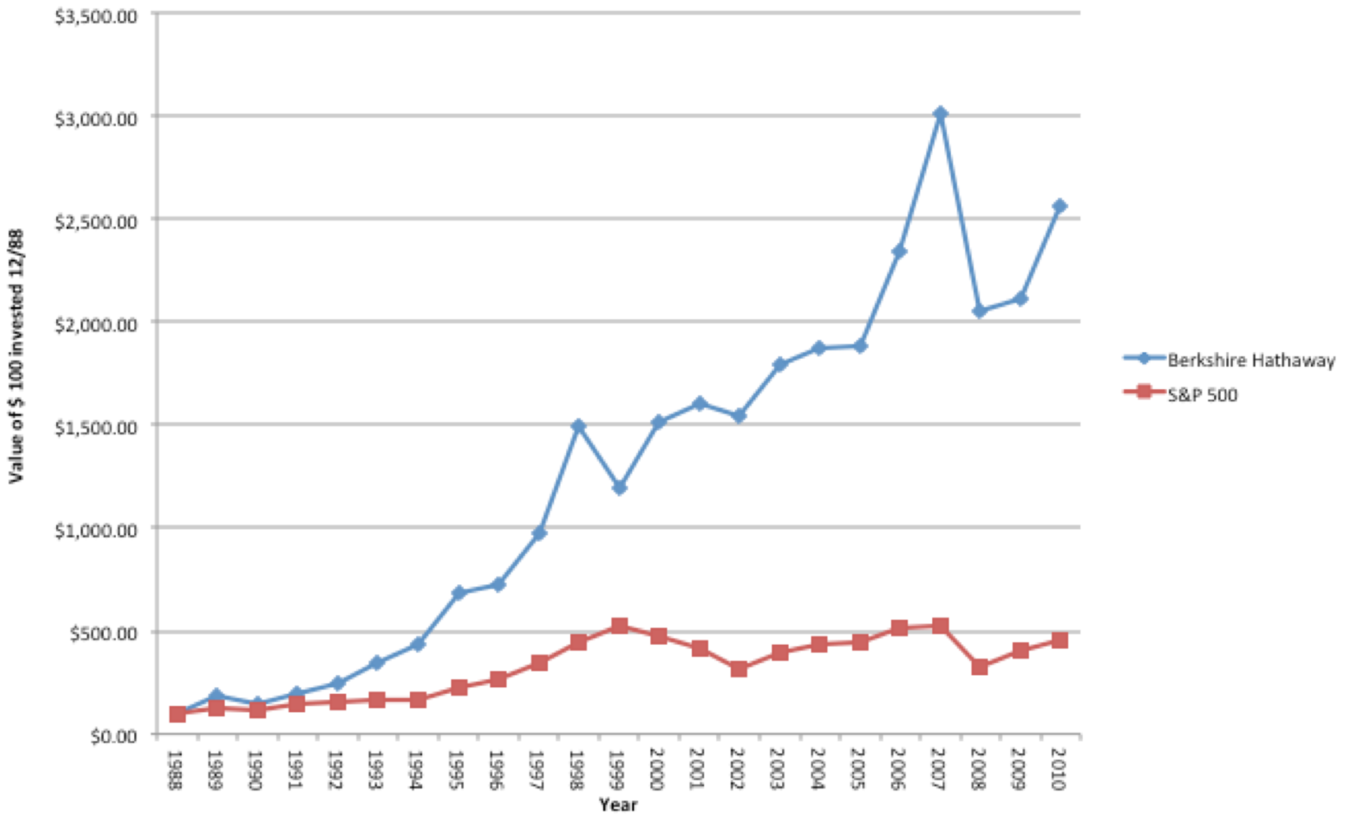
1. PE of the stock has to be less than the inverse of the yield on AAA Corporate Bonds:
2. PE of the stock has to less than 40% of the average PE over the last 5 years.
3. Dividend Yield > Two-thirds of the AAA Corporate Bond Yield
4. Price < Two-thirds of Book Value
5. Price < Two-thirds of Net Current Assets
6. Debt-Equity Ratio (Book Value) has to be less than one.
7. Current Assets > Twice Current Liabilities
8. Debt < Twice Net Current Assets
9. Historical Growth in EPS (over last 10 years) > 7%
10. No more than two years of negative earnings over the previous ten years.

How well have Graham's screens performed?

- Graham's best claim to fame comes from the success of the students who took his classes at Columbia University. Among them were Charlie Munger and Warren Buffett. However, none of them adhered to his screens strictly.
- A study by Oppenheimer concluded that stocks that passed the Graham screens would have earned a return well in excess of the market. Mark Hulbert who evaluates investment newsletters concluded that newsletters that used screens similar to Graham's did much better than other newsletters.
- However, an attempt by James Rea to run an actual mutual fund using the Graham screens failed to deliver the promised returns.

The Buffett Mystique

Figure 8.1: Value of $100 invested in 1988: Berkshire Hathaway vs S&P 500



Buffett’s Tenets

- Business Tenets:
  - • The business the company is in should be simple and understandable.
  - • The firm should have a consistent operating history, manifested in operating earnings that are stable and predictable.
  - • The firm should be in a business with favorable long term prospects.
- Management Tenets:
  - • The managers of the company should be candid. As evidenced by the way he treated his own stockholders, Buffett put a premium on managers he trusted. • The managers of the company should be leaders and not followers.
- Financial Tenets:
  - • The company should have a high return on equity. Buffett used a modified version of what he called owner earnings
    - Owner Earnings = Net income + Depreciation & Amortization – Capital Expenditures
  - • The company should have high and stable profit margins.
- Market Tenets:
  - • Use conservative estimates of earnings and the riskless rate as the discount rate.
  - In keeping with his view of Mr. Market as capricious and moody, even valuable companies can be bought at attractive prices when investors turn away from them.

Updating Buffett's record

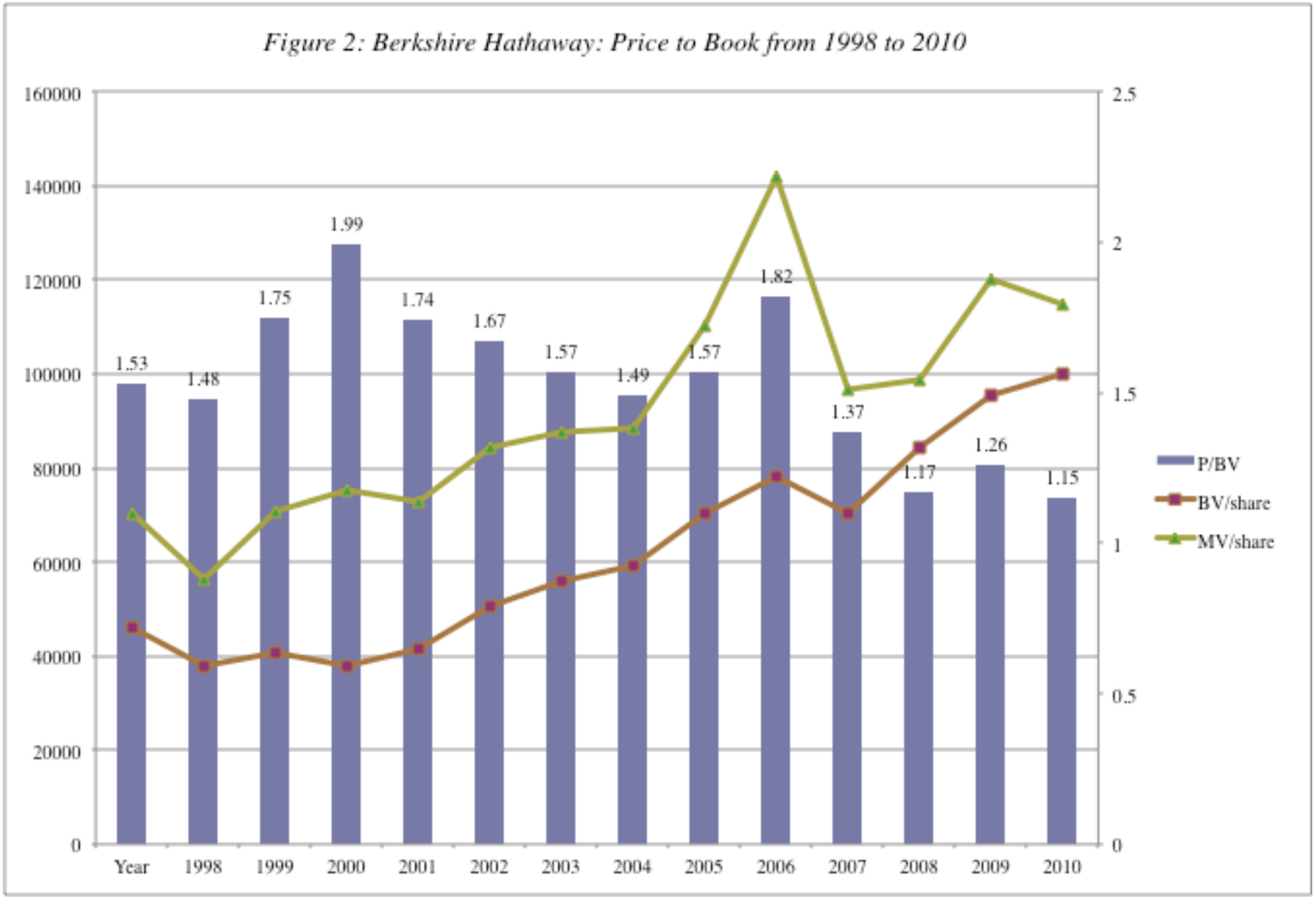


Figure 2: Berkshire Hathaway: Price to Book from 1998 to 2010

So, what happened?

- Imitators: His record of picking winners has attracted publicity and a crowd of imitators who follow his every move, buying everything be buys, making it difficult for him to accumulate large positions at attractive prices.
- Scaling problems: At the same time the larger funds at his disposal imply that he is investing far more than he did two or three decades ago in each of the companies that he takes a position in, creating a larger price impact (and lower profits)
- Macro game? The crises that have beset markets over the last few years have been both a threat and an opportunity for Buffett. As markets have staggered through the crises, the biggest factors driving stock prices and investment success have become macroeconomic unknowns and not the company-specific factors that Buffett has historically viewed as his competitive edge (assessing a company's profitability and cash flows).

Be like Buffett?

1. A different market: Markets have changed since Buffett started his first partnership. Even Warren Buffett would have difficulty replicating his success in today’ s market, where information on companies is widely available and dozens of money managers claim to be looking for bargains in value stocks.
2. Insider game: In recent years, Buffett has adopted a more activist investment style and has succeeded with it. To succeed with this style as an investor, though, you would need substantial resources and have the credibility that comes with investment success. There are few investors, even among successful money managers, who can claim this combination.
3. Patience: The third ingredient of Buffett’ s success has been patience. As he has pointed out, he does not buy stocks for the short term but businesses for the long term. He has often been willing to hold stocks that he believes to be under valued through disappointing years. In those same years, he has faced no pressure from impatient investors, since stockholders in Berkshire Hathaway have such high regard for him.