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Value Investing: A New Look

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Value Investing Defined

Value investing consists of quantifying what something is worth intrinsically, based primarily on its fundamental, cash flow-generating capabilities, and buying it if its price represents a meaningful discount from that value.

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The Essential Principles of Value Investing

- The understanding of securities as stakes in actual business.
- The focus on true worth as opposed to price.
- The use of fundamentals to calculate intrinsic value.
- The recognition that attractive investments come when there's a wide divergence between the price at which something is offered in the market and the actual fundamental worth you've determined.
- The emotional discipline to act when such opportunities are presented and not otherwise.

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Development of Value/Growth Dichotomy

- Ben Graham and "cigar butts" – the original low-valuation style.
- Warren Buffett turns to "great businesses at fair prices."
- 1960's: the emergence of growth stocks of companies innovating in technology or marketing.
- Veneration of the Nifty Fifty, for which there was "no price too high."
- The value school pushes back, with emphasis on low valuation metrics.
- "Growth" and "value" go from schools of thought to job descriptions and allocation buckets.
- Growth and value have both had their day, but value investing has underperformed since 2007.

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Value Investing Today

Under today's hardened definition, value investing is characterized by some or all of the following:

- Thesis based on today's operations, earnings and asset values.
- Not dependent on speculation about the future.
- Mostly prosaic industries, certainly not high-tech.
- High degree of predictability, limited uncertainty and a narrow range of possible outcomes.
- Strong defensive qualities.
- Low valuation relative to fundamentals.

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Value Investing Today

The value investor’s view of value versus growth is as follows:

- Value stocks, anchored by today’s cash flows and asset values, should *theoretically* be “safer” and their returns more reliable, even if they’re unlikely to earn returns as high as those on winning companies that grow rapidly into the distant future.
- Growth investing often entails belief in unproven business models and thus the risk of serious setbacks, requiring investors to have deep conviction to be able to hang on.
- When they’re rising, growth stocks reflect a level of optimism that can evaporate during corrections, producing above average losses and testing even the most steeled investor.

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Value versus Growth

I don’t believe pioneers like Ben Graham and Warren Buffett intended for there to be such a sharp line of demarcation between value investing and growth investing.

- Graham presumably engaged in “cigar butt” investing because it was uncrowded, profitable and low in risk. It might not be his exclusive focus today.
- Warren Buffett is famous for his investment in Coca-Cola, a member of the Nifty Fifty.
- Both men derived a large share of their success from investing in GEICO, a growth company.

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He Oughta Know

> . . . we think the very term “value investing” is redundant. What is “investing” if it is not the act of seeking value at least sufficient to justify the amount paid? . . . Typically, [the term “value investing] connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth . . . Correspondingly, opposite characteristics – a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield – are in no way inconsistent with a “value” purchase.

Warren Buffett, 1992 shareholder letter

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A Changed World

Everyone dreams of investments where they can make a lot of money without bearing much risk. But since everyone's looking, to be the one who finds them you need an edge – you have to know something others don't.

Seventy years ago, the markets were much less efficient:

- There were no computers or data feeds.
- A little effort would enable you to garner information others didn't have.
- Few people understood the concept of underpriced value or how to find it.

The market was a "dumb place" where bargains could be found in plain sight.

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A Changed World (cont'd)

Today, in contrast:

- Companies are legally required to make complete and uniform disclosure.
- All investors have computers and access to every bit of data.
- They can screen the universe against a set of criteria in a matter of seconds.

Thus it doesn't make sense to think it's possible to get an investing edge on the basis of readily available, current quantitative information. Everyone else has it too.

Instead, investment superiority has to come from having a better understanding of (a) the significance of current qualitative factors and/or (b) the likelihood of success in the future.

Even value investors can't avoid making judgments about these things.

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A Changed World (cont'd)

Twenty-five years ago, we used to speak of "defensive industries" and companies with "moats."

More recently, information technology and digitalization have changed the world, dividing companies into "disruptors" and "disrupted." Moats have evaporated. Many businesses have become fallen prey to tech-savvy newcomers.

Thus investors can't safely stay ignorant regarding technology's potential.

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A Changed World (cont’d)

Technology is changing every industry, and the companies creating that technology are prospering as never before. Here are but a few of the many changes favoring tech companies:

- Because of global markets and the growth potential of the Internet and software, tech firms can become much more valuable than we previously could have imagined.
- Since many of these companies are selling products primarily made with code, their costs and capital requirements are extremely low and their profitability unusually high.
- Because the friction and marginal cost of scaling over the Internet can be so low, businesses can grow much more rapidly with less capital investment than ever before.
- As developing and scaling new products is much easier in the digital world, it’s never been more possible for companies to develop new avenues of growth, extending their runways.
- The moats protecting today’s winners have never been stronger, and thus far it seems the winners have often gotten more powerful and more effective as they got bigger.

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Is It Different This Time?

Fans of technology stocks say things are different, in that today's successful tech companies have unprecedented potential for long runways of high growth, superior economics, and significant durability. But we likewise heard how things were different in connection with the Nifty Fifty in the 1960s and in the tech bubble of the late '90's.

On the other hand, some things surely remain unchanged. These include the tendency of bull markets to value all competitors as if they'll be successful and to take tech stocks to very high valuations, from which the unsuccessful ones will show great declines.

Fundamental investors need to thoroughly examine all situations – even those with dependency on intangible assets and growth into the distant future – with the goal of achieving insight.

This needn't be antithetical to the value investor's mentality.

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My Message

This talk isn't about advocating growth over value. My purpose is to explore the mindset that will prove most successful for value investors over the coming decades, regardless of what the market does in those just ahead. It's important that investors recognize:

- That the potential range of outcomes for many of today's companies is very wide.
- That there are considerations with enormous implications for the ultimate value of many companies that do not show up in readily available quantitative data.

Determining the appropriateness of a market price requires deep micro-understanding. That makes it impossible to opine on the valuation of a rapidly growing company from 30,000 feet or by applying traditional value parameters to superficial projections.

The key, as always, is to understand how today's market price relates to the company's broadly defined intrinsic value, including its prospects.

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My Message (cont'd)

What I'm saying is:

- Open-mindedness is something we should strive for.
- There shouldn't be such a big distinction between value and growth.
- Without attaining real knowledge and fully understanding the positive case, it's impossible to justify the dismissiveness that many of us exhibit early on in the face of innovation.
- Stocks shouldn't automatically be excluded just because they're from technology companies or rapidly growing companies, or because they carry above average valuations.

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Conclusions

- Value investing doesn't have to be about low valuation metrics. The fact that a security carries a high p/e ratio doesn't mean it's overpriced, and the fact that another has a low p/e ratio doesn't mean it's a bargain.
- The fact that a company grows rapidly, relies on intangibles such as technology for its success and/or has a high p/e ratio doesn't mean it can't be invested in on the basis of intrinsic value.
- The fact that a company is expected to grow rapidly doesn't mean it's unpredictable, and the fact that another has a history of steady growth doesn't mean it can't run into trouble.
- Not all companies that are expected to grow rapidly will do so. But it's very hard to fully appreciate and fully value the ones that will.

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The Last Word

We don't consider ourselves value investors. We consider ourselves investors, . . . There is no such thing in our mind as value or growth investing . . .

Warren Buffett, May 2019

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