FP Answers: What exactly is value investing? A beginner's guide

Here are 4 key points to understanding what it is and how it works

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Q: I have friends who say they are value investors. How are they picking their stocks? What is value investing exactly and what are the key metrics for picking stocks that will do well? — *Damian*

FP Answers: Value investing helps investors find and buy stocks that trade significantly below their intrinsic value, which is determined by looking at the financial fundamentals of a stock. According to Ben Graham, the father of value investing, a value investor wants to buy a stock that is worth $1 for just 50 cents.

Here are some key points for understanding who value investors are, what they believe in and the process of value investing itself.

Who are value investors?

They are long-term, bottom-up fundamental investors who study a stock or company's financial statements, their competitors and markets, along with economic factors in the economy such as gross domestic product, unemployment, interest rates and production.

They arrive at an intrinsic value of a stock using long-term fundamentals. The intrinsic value is not affected by short-term announcements and press releases, but by factors such as whether the company operates in a free-entry environment, is well-managed, has a good business model and is conservatively financed.

If the stock price is well below the intrinsic value by what is known as the margin of safety — which in effect means only buying a stock when the market price is substantially less than its intrinsic value — then value investors invest. Otherwise, they stay on the sidelines.

What do they believe in?

Three principles are key. First, value investors believe they're buying the company when they buy its stock, so they want to know a lot about the company.

Second, since stocks often go up or down for reasons unrelated to fundamentals, they try to take advantage of such movements as opposed to following them. This means value investors need to be cautious when everyone else is exuberant, and they should look for opportunities when investors panic.

Third, value investors always look for a margin of safety. The margin of safety was 50 per cent in Ben Graham's time, but has now come down to one-third of the intrinsic value. Since valuation deals with the future in an uncertain world, so it's subject to mistakes and inaccuracies, the margin of safety protects your downside.

What process do they follow?

To find stocks worth buying — that is, those that meet the margin of safety — value investors follow a three-step process.

First, they screen stocks by forming portfolios based on metrics such as P/E (calculated by dividing the market value price per share by the company's earnings per share) or P/B (calculated by dividing a company's market capitalization by its book value of equity as of the latest reporting period) and focus on the stocks with the lowest values.

These are the stocks with the lowest price in relation to their fundamentals (that is, the cheapest at first glance). The screening allows investors to identify possibly undervalued stocks and reduce the number of stocks they will consider in depth.

Second, the possibly undervalued stocks selected in the first step are now valued to determine their intrinsic value using both asset-based and cash-flow-based valuation approaches. Third, they make a decision using the margin-of-safety concept. A stock is truly undervalued only when its price is below the intrinsic value by at least a third.

Academic research on the performance of the lowest (so-called value stocks) versus highest (so-called growth stocks) P/E or P/B portfolios has shown that it works. The lowest P/E or P/B portfolios beat the highest in the long run by anywhere from seven per cent to 13 per cent depending on the market and the country.

Why does value investing work?

The weaknesses in human nature combined with the conflicts that portfolio managers have when they manage other peoples' money leads to the outperformance of value investors.

Humans are not rational. They naively extrapolate past performance, they overact, they are overoptimistic and overconfident, and they herd. They are also impatient and panic. The average mutual fund has returned more than eight per cent annually in the United States over the past 30 years, but the clients invested in these funds have only made two per cent.

At the same time, institutional investors have conflicts when they manage other peoples' money that force them to herd, portfolio rebalance throughout the year and window dress. They herd to protect their jobs, they systematically rebalance their portfolios to affect their Christmas bonus, and they window dress in the last quarter of the year to spruce up their portfolios so that clients see that they only hold good, glamour stocks when they get their annual reports.

As human nature weaknesses and institutional biases are not going to go away any time soon, value investing will continue to work irrespective of how many people study it or insist they are value investors. Everyone wants to say they are value investors, but only a few really are.

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, Western University. He is the author of Value Investing: From Theory to Practice and the founder and managing director of the Ben Graham Centre in Value Investing, which runs, among other events, a Value Investing Conference on April 10, 2024, and a five-day Value Investing Seminar between June 3 and 7, 2024.