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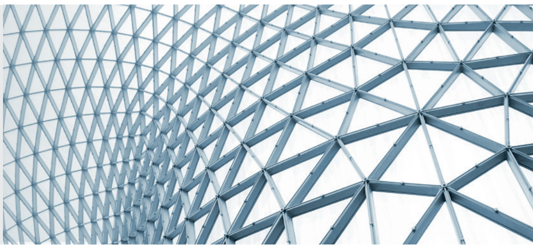

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Value investing – Is it different this time?

A value investor usually requires a substantial price discount at the company's intrinsic value. But the latter exceeds the mere accounting value of its tangible assets.

Key Takeaways:

- The core principles of Value Investing have been defined by Ben Graham and David Dodd in their book "Security Analysis" in 1934. Graham's idea of a "margin of safety" translates to purchasing a stock if and only if it is priced at a sufficient discount to the company's intrinsic value.
- The precise understanding of what the company's intrinsic value is has been challenged again and again over time. With the emergence of FAANGs over the last 20 years, the notion has become more and more prominent that a large part of a company's intrinsic valuation is intangible and cannot be found on a balance sheet.
- Between Warren Buffet, student of Graham, and the burst of the DotCom bubble, the question persists: How does one establish the margin of safety for the potential of a company to generate value?

During the internet bubble in the late 1990s, it was common to hear other investors say, "It's different this time," as justification for their investments in internet stocks. They claimed the old rules of valuation no longer applied to the internet economy.

The pace of technological innovation was so rapid that the next technology was thought to be just around the corner, quickly making the current technology obsolete and, thus, the created assets not durable. For the internet stocks, cash flowed mainly out of the business and earnings were promised, but in the distant future. The stock market had a preference for explosive growth and a corresponding indifference to valuation.

Daniel Nicholas
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To start 1999, the 10 largest stocks accounted for 21% of the S&P 500 Index and included Microsoft, Intel, IBM and Cisco Systems. After the Vanguard Growth Index returned over 27 points above its Value Stock Index in 1998, these 10 stocks entered 1999 trading at a 44 times price-earnings (P/E) ratio. In the end, we know how the story played out. Value was not dead and the vilified value investors were vindicated.

Twenty years later, though, some of today's high-flying stocks, including the FAANGs (i.e., Facebook, Amazon, Apple, Netflix and Google) are drawing comparison to the internet bubble. FAANGs are actually making it into value portfolios, despite the fact that they trade on average at 34 times next 12-months GAAP (Generally Accepted Accounting Principles) earnings. After 10 years of value indexes underperforming growth, are value managers who own FAANGs drifting away from their value roots? Or could it be different this time?

Birth of value investing

Let's go back to the start of value investing to determine what, if anything, has changed. In 1934, Ben Graham and David Dodd wrote Security Analysis, which was quickly adopted as the Bible of value investing. In it, Graham explained his idea of only investing when he had a "margin of safety," meaning he purchased a stock when it was priced at a large discount to a company's intrinsic value. The concept remains a core principle of value investing today even though the idea is almost 100 years old.

Back in the 1930s, influenced by just having been through a depression, a company's intrinsic value was defined as its liquidation value.

Therefore, Graham proposed the following formula: A stock passed his margin-of-safety test only if it sold for a large discount to this estimated liquidation value.

The next 40 years

Over the next 40 years, stock prices were generally quite tightly tied to their book values and patient investors could often find companies that were out of favor, trading below estimated liquidation value. The asset-heavy economy made it appropriate to value businesses based on their tangible assets. In fact, as recently as 1975, 83% of the stock market value of the average company was represented by its tangible book value.

However, in an economy where value was derived from fixed assets, it was hard to maintain a competitive edge. If you earned unusually high returns, others would duplicate your fixed assets and your advantage disappeared. That made it difficult for companies temporarily trading at large premiums to book value to sustain their high stock prices. So an effective investment approach was to buy the stocks priced at discounts to book value and then patiently wait for reversion to the mean.

1980s to present

By the early 1980s, the Berkshire Hathaway investment portfolio, managed by Warren Buffett, looked nothing like the low price-to-book investments favored by his teacher Graham. The portfolio included General Foods, RJ Reynolds, Time Inc. and Washington Post Co. When asked about the apparently high prices he paid for those companies relative to their book value, Buffett was fond of saying that their most valuable assets—their brand names—were not even on their balance sheets. At the time, he was quoted saying, *"My own thinking has changed drastically from 35 years ago when I was taught to favor tangible assets and to shun businesses whose value depended largely on economic goodwill."*.

By citing the decreasing importance of tangible assets in determining business value, this quote sounds as timely now as when it appeared in Berkshire's 1983 Annual Report. What Buffett figured out earlier than most value investors was that conservative accounting rules overlooked the value of intangible assets (e.g., brand names, customer lists, R&D spending and patents). In turn, book value didn't fully reflect the economic value of businesses with strong brands.

In today's asset-light economy, intangibles have become more important. The relative significance of tangibles compared to intangibles has completely flip-flopped from what it was 40 years ago. They now account for over 80% of the average company's market value. Much like Graham, however, GAAP doesn't even attempt to value those assets.

For example, for companies in the S&P 500 today, the correlation between stock price and tangible book value has become quite small, just 14%. This is a very big change from 25 years ago when that correlation was 71%—or five times stronger than it is now. Unlike then, knowing the book value of a company gives little clue as to its stock price.

Valuing businesses in 2019

With this change in the global economy, the technique for finding margin of safety has changed. Authors Feng Gu and Baruch Lev believe it's time for investors to change their investment model[1]. Put simply, they believe forecasting earnings has lost relevance and even a perfect prediction of corporate earnings no longer yields substantial gains for investors. They advocate for "changing the focus of security analysis and valuation from earnings to a broader, long-term competitive analysis, based primarily on non-GAAP data."

We agree with this "new" approach since we have been doing so for more than 40 years. We seek out investments whose economic value is not easily seen in the simple GAAP metrics of net income and book value.

Over this time period, we have owned several packaged food companies when we thought increased brand advertising understated earnings. We have owned cable TV distributors that reported net losses and negative book value while rapidly increasing their subscribers. And we have owned high-growth biotech companies that sold at lower P/Es than mature pharmaceutical companies once we treated their R&D expenditures as long-term investments. We believe today's earnings and P/E ratio is a very poor indicator of the true value of FAANGs, so we apply different statistics that best capture each company's unique intrinsic value. As intangibles have grown in importance, the thought process is no different than what led us to own food and cable stocks early in the 1980s. Today, it simply applies to more companies.

Finding value investors

In a world where business value rests primarily on intangible assets, it's also harder to use a style box to understand a portfolio manager's investment approach. Though our portfolios still typically have a lower P/E than the market, we are more frequently investing in "exceptions" where the GAAP P/E looks expensive. For those "exceptions," true value investors should be able to explain how they calculate their margin of safety: What are they getting that they don't think they're paying for?

For example, we currently have a holding in Alphabet, despite the fact that it trades at 22 times reported next 12-month earnings and is owned by many growth managers. To determine the company's intrinsic value, we use a sum-of-the-parts approach. Alphabet has more than just Google, the world's leading search engine. To find the valuation of all non-Google assets, we value cash, cumulative investments in venture capital-like projects (they own Waymo, the leader in autonomous driving technology) and YouTube. Together, these investments contribute nothing to Google's current earnings, despite having tremendous value. These investments are what we're getting for free, which creates our margin of safety in investing in Alphabet. Our analysis reveals that the market is pricing Google around 14 times earnings, which is a level too low for a business that has very low incremental capital needs, high market share and a strong industry tailwind that will power revenue growth of 20% or more for the foreseeable future.

In summary

So, in fact, it isn't different this time. Value investing is still defined as margin of safety. However, the technique for finding margin of safety has evolved for many investors. Regardless of the changing metrics that determine a company's value, the main concepts of value investing are the ones from 84 years ago when Security Analysis was first published:

- Investors follow fads, get emotional and overreact,
- Which means stock prices sometimes decouple from intrinsic value,
- Allowing patient investors to invest when price is below value,
- Which creates a margin of safety.

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1 Feng Gu and Baruch Lev. Time to Change Your Investment Model Perspectives- Financial Analysts Journal | A Publication of CFA Institute CE Credits: Volume 73 Number 4 © 2017 CFA Institute

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