

# the value of value investing

## Introduction

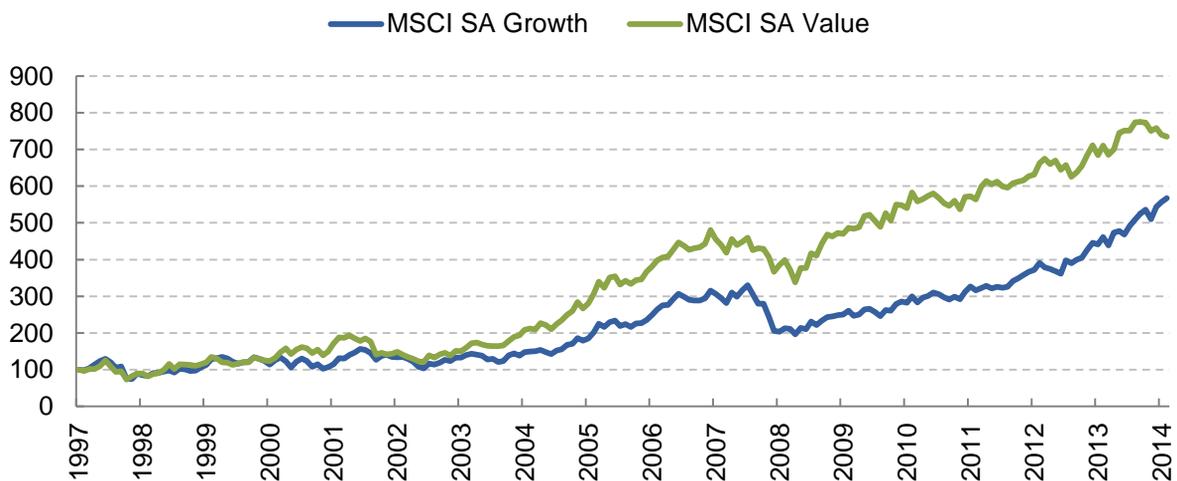
The value approach to investing has of late been the recipient of a wall of criticism with graffiti-like headlines, ranging from “Why value investing is so hard” to the hackneyed phrase “The Death of Value Investing”.

Value investing seems to have fallen out of favour following several years of underperformance by respected value managers both locally and internationally. Contrary to many of the sceptics’ views on the matter, we do not believe that this is a secular trend but rather a function of the normal value “alpha” cycle which has persisted for the past 40 years<sup>1</sup>. We have highlighted in previous articles<sup>2</sup> that the big contributing factor to the recent underperformance by value managers is the artificially depressed interest rates, which were deemed necessary following the Global Financial Crisis.

As can be seen in the chart below, value investing has outperformed the market over the long term. There is impeccable academic evidence supporting this long-term track record of outperformance. Rather than referencing the reams of research and falling into the trap of confirmation bias we instead tried to find evidence to the contrary. The results were quite disappointing, with no concrete factual evidence against the existence of the value premium.

## Value investing outperforms over the long term

**The Value of R100 invested in MSCI SA Growth and Value**



Source: Factset

Several years ago, a study by a leading asset consultant revealed that around 70% of South African fund managers follow a value investment style. A strategy can only work if there are few people following it and hence critics will argue that the South African equity market is too small and the benefits of a value approach to investing have therefore been arbitrated away. This is not the reason for the recent lag in performance by value managers.

<sup>1</sup> As measured by the MSCI World Value vs. Growth Index since 1974

<sup>2</sup> Refer “the great rotation, a roadmap for the rest of the decade”, Ricco Friedrich, Cognition 1st Quarter 2013

# the value of value investing

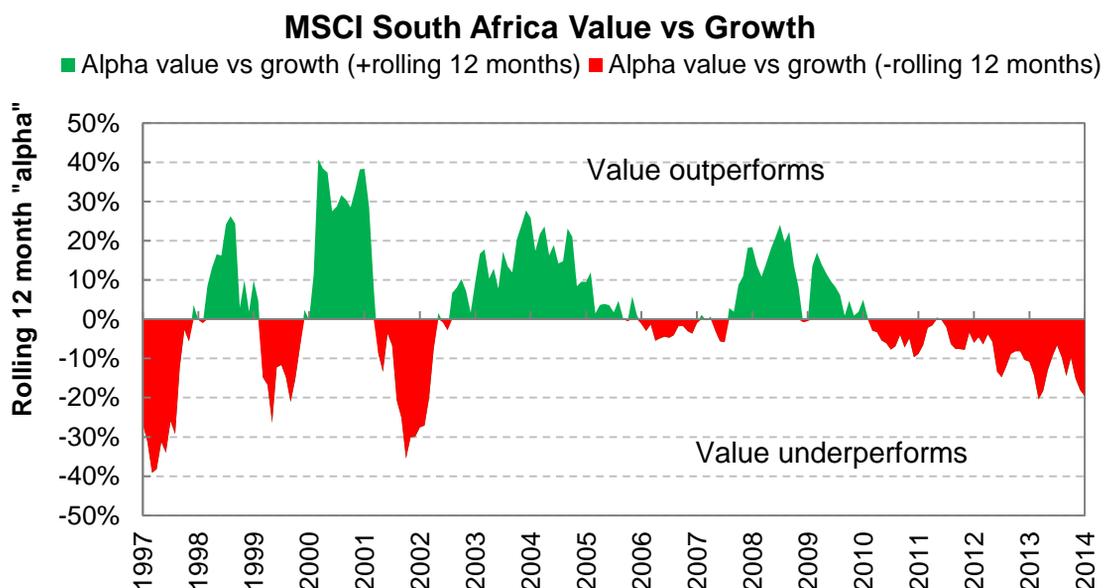
## The value cycle

Like the overall stock market, the relative performance of value stocks may go through cycles when it suffers from periods of underperformance. The chart below highlights the cyclical nature of the rolling 12-month performance of value investing relative to growth as measured by the respective MSCI indices for South Africa.

There have been four cycles in which value has outperformed relative to growth. These cycles are not necessarily correlated to the stock market, although in South Africa value does seem to underperform while stock market PEs are expanding. The latest period of underperformance has lasted longer than any previous cycle. Over this period the PE of the FTSE/JSE All Share Index has increased over 50% from 12x to over 18x. This significant expansion in PE multiples was driven by industrial shares. Looking back at the previous cycles when value underperformed, in 1999/2000 it was the tech bubble which pushed market PEs up; in 2007/2008 it was resource shares. Other macro factors which have a significant impact on the value cycle include:

1. Market volatility – in times when volatility increases and risk aversion is on the rise, value stocks become less attractive to investors;
2. Economic growth - value companies do better when economic growth and growth in corporate profits are anticipated to improve;
3. Interest rates – these capture the macroeconomic cycle and tend to be pro-cyclical, i.e. as economic growth improves, central banks raise rates to slow inflation and vice versa in recessions.

### The Value “alpha” cycle in South Africa



# the value of value investing

***“All things excellent are as difficult as they are rare”, Spinoza***

Anyone whose investment approach relies heavily on quantitative methods as espoused by Benjamin Graham scholars and popularised in David Dreman’s book, “Contrarian Investment Strategies” is probably in for a nasty surprise. Even Benjamin Graham cautioned, “Any approach to moneymaking in the stock market which can be easily described and followed by a lot of people is by its terms too simple and too easy to last.”

*We do not subscribe to the notion that value investing is simply about buying companies with the lowest PE, highest dividend yield or lowest price to book value. Very few of these valuation metrics yield persistency and therefore are not very useful in implementing a practical and repeatable approach to investing. In fact, one of the key principles we follow in our decision making process is: if our detailed due diligence reveals that the only reason to invest in a company is because it’s cheap, then the company is more than likely a bad investment.*

Value investing in South Africa comes in many different stripes, such as “deep value”, “relative value”, “contrarian value” and “cyclical value”. Each of these chosen approaches borrows an element of value investing based on a manager’s particular preference. While these approaches are sufficiently different as to yield varying outcomes, following a narrowly defined approach as described by some of these methods is dangerous in a small market like South Africa with only really 120 potential investment opportunities.

## ***Risk: the possibility of injury or loss***

There is one aspect of investing that we believe is a significant differentiator among value managers but seldom receives close scrutiny by consultants and advisers. This is the concept of risk. Most investors are primarily focussed on return without considering how much they stand to lose.

We are not referring to the standard definition of risk often quoted by value managers which Seth Klarman (an avid student of Benjamin Graham) referred to in his rare book, “Margin of Safety”, but rather the appetite for risk which we as individuals grow up with. In the same way that it’s hard to teach someone how to use their brain, risk is something people learn from experience. Two investment managers may have a similar view on the prospects of a company and the potential mispricing opportunity, but given different risk profiles may implement the decision very differently, with one manager taking a very small stake while another may allocate substantially more capital. The combination of repeating this process in building a portfolio may result in substantially different outcomes for fairly similar approaches.

To further differentiate themselves from the crowd, value managers will overlay a quality aspect. Simply put, they will buy good quality businesses that are trading below their intrinsic value. I have never met anyone who has said, “I like to buy poor quality businesses”, so arguably this is not a key point of differentiation. Furthermore, investing in good quality companies does not always translate into good quality investment returns. Applying this method without reference to valuation may place an investor in popular, overvalued stocks.

In much the same way that growth is a component of the value of a company, so too is the quality of the business. These factors are joined at the hip and cannot be looked at independently in the investment decision process. The potential return opportunity to shareholders in a company comes from three sources.

1. The value of the potential cash flow stream which the business is capable of generating and is either available to distribute to shareholders or invest in new opportunities, i.e. the value of the existing assets in terms of their earnings power as compared to the price;

# the value of value investing

2. The number and size of potential growth opportunities available to management which can generate returns above the cost of capital, i.e. the future value;
3. How successful management is in allocating capital and deploying resources (borrowed or generated internally) into new opportunities. This is dependent on factors like the quality of the economic moat or the quality of the people driving the strategy and decision making.

A “deep value” investor may only focus on the first source, while a growth investor will focus primarily on the second source. A quality investor will place greater emphasis on the 3<sup>rd</sup> source.

The best investment opportunity is one that combines all of the above creating a lollapalooza<sup>3</sup> effect. It makes little sense to follow only one of these sources of potential return.

***There are no short cuts to successful investing – hard work, discipline and a long-term time horizon are essential.***

Obviously value investing is not for everyone, it simply does not work for those trying to predict short-term price movements. Asset manager Jean-Marie Eveillard said, in response to the question of why there aren't more value investors, given Buffett's success, "If you are a value investor, every now and then you lag, or experience what consultants call tracking error. It can be very painful. To be a value investor, you have to be willing to suffer pain."

The approach to value investing has evolved since Graham and Dodd published their book, “Security Analysis”, in 1934. Ben Graham had himself been critical of the relevance of some of these methodologies before he died - and that was in 1976<sup>4</sup>.

However, there are many sound principles which he covered in both *Security Analysis* and *The Intelligent Investor* which have stood the test of time. These are:

1. Stick to fundamental analysis – i.e. invest rather than speculate. Do not try and predict short-term earnings as part of forecasting investment returns. Short-term price fluctuations are irrelevant when they do not affect intrinsic value. Do not overpay for the promise of future growth, which may or may not materialise. *“First we wanted to make sure that we were getting ample value for our money in concrete, demonstrable terms. We were unwilling to accept the prospects and promises of the future as compensation for a lack of sufficient value in hand<sup>5</sup>”.*
2. Focus on the element of safety and conservatism. Value investing is the only approach that puts risk at the heart of the process. In understanding the potential to suffer a permanent loss of capital we focus on understanding the valuation risk, business/earnings risk and balance sheet/financial risk. In Ch. 11 of “Security analysis”, Graham states that *Experience has shown that in most cases safety resides in the earning power, and if this is deficient the assets lose most of their reputed value.*

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<sup>3</sup> As described by Charlie Munger, a lollapalooza effect is a combination of factors, filtered through multidisciplinary models, that leads to an outstanding result.

<sup>4</sup> A conversation with Benjamin Graham, *Financial Analyst Journal*, September/October 1976

<sup>5</sup> *The Intelligent Investor*, Stock Selection for the Defensive Investor

# the value of value investing

3. Do not try to forecast long and short term changes in the economy. The future is almost entirely uncertain. Inflation and interest rates are unreliable, economic recessions come and go at random, geopolitical events, such as Russia, arrive without warning and commodity shortages come and go. We do not suggest ignoring the macro factors as they do have an important bearing on the prospects of a company, just don't make forecasting exchange rates and commodities your central objective, as you will fail miserably.
4. Small cap value provides some of the best opportunities. Large cap stocks are covered extensively by both sell side and buy side analysts and hence do not tend to be as mispriced as some less followed small cap stocks.
5. Capitalise on hope, fear and greed. Value investing *"is a technique by which true investors can exploit the recurrent excessive optimism and excessive apprehension of the speculative public"*<sup>6</sup>.
6. Be unconstrained and don't follow the crowd. Be free to exploit value opportunities wherever they may occur, rather than being pigeonholed.

Unless any of these factors above are about to change, value investing will be around for a very long time.

## **Pitfalls**

There is no holy grail of investing and one needs to recognise and understand the potential pitfalls of any type of investment approach. Value investors know there are no perfect investments, rather they figure out what is wrong and proceed if what appears to be wrong is not a show stopper. These problems may include a near-term outlook which is weak or industries which are depressed or in decline.

For value managers, so-called value traps are by far the most important of challenges to overcome. These typically arise due to a change in the earnings power of a company which is more permanent in nature than cyclical.

We have spent a lot of time thinking about these challenges and have developed various mental models to avoid this common pitfall. These include applying our expectations framework to each investment opportunity, regularly assessing investments which have gone against us (if the facts have changed, it is never wrong to change your mind) and ensuring that we are not overly concentrated in any one area of the market.

## **Conclusion**

The fact that value outperforms over the long term is not news. Yet despite this, there are very few true value managers. In the same way, knowing that a safety belt can reduce the risk of death in a car accident doesn't always translate into people buckling up. To benefit from a value investment style, patience is required during periods of underperformance. Long-term time horizons are required and they do not come naturally to humans. As Keynes said, "Investment based on genuine long-term expectations is so difficult today as to be scarcely practicable".

Of late, value managers have struggled to keep up with the overall returns of the market, particularly as the prices of expensive stocks continue to move higher. In a world where GDP growth has been depressed and interest rates have been kept artificially low, the search for companies with short-term earnings momentum and defensive earnings qualities has resulted in a significant disconnect in valuations.

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<sup>6</sup> A conversation with Benjamin Graham, Financial Analyst Journal, September/October 1976

# the value of value investing

This dispersion of valuations between the lowest priced stocks and the highest price stocks is at the greatest level since 1997/1998<sup>7</sup>. That was a time of significant discrepancies in valuations and value investing was very much out of favour. Resources were unloved, and financial stocks were the glamour stocks. Today, it is the industrial stocks which find significant favour with investors while resources are once again out of favour.

The size of the spread is normally a signal for the magnitude of the forthcoming reversal<sup>8</sup>. As investment returns are determined by the price that you pay, we believe that the current entry point of the stocks we have allocated capital to will provide investors with better return prospects than many of the overvalued stocks which make up a large component of the FTSE/JSE All Share Index.

## Other references

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Based on the PE ratio of the most expensive group (top quartile) of companies versus the cheapest (bottom quartile)

Jason Hsu, The Value Premium is Mean Reverting

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<sup>7</sup> Based on the PE ratio of the most expensive group (top quartile) of companies versus the cheapest (bottom quartile)

<sup>8</sup> Jason Hsu, The Value Premium is Mean Reverting