

Value Investing





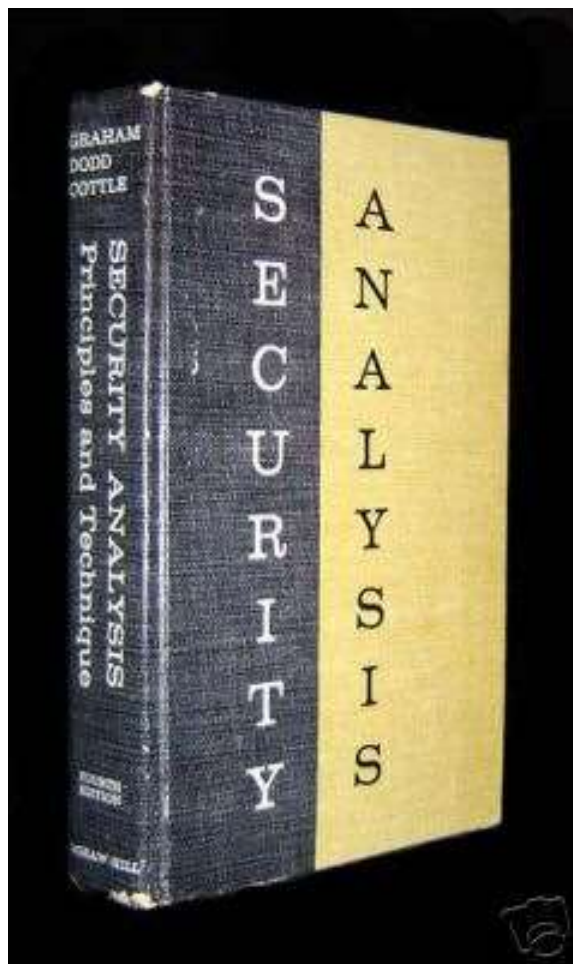
Value Investing

- Finding securities considered to be temporarily undervalued or unpopular for various reasons.
 - Determine *Economic Value* of the firm
 - Sometimes called Fundamental Value
 - Compare to current price

- Value investing is a contrarian philosophy
 - Not following the herd...

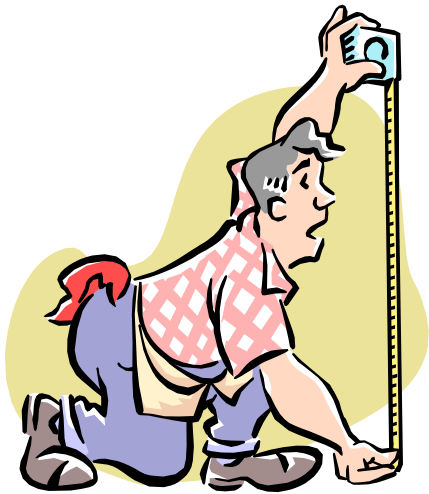
- Why might a stock be selling below its economic value?

Graham & Dodd Approach



- Coauthors of *Security Analysis*—value investor’s bible
 - Graham lost fortune in 1929 crash.
 - Learned that true measure of stock values come from earnings, dividends, future prospects, and asset values, NOT price movements
- Graham teamed up with professor Dodd to write the book, 1934

ASSETS



STOCK

- Most important idea: margin of safety—positive difference between price and value
- Degree of “bargain-ness”
- Enlightened stock analysis—price vs. true intrinsic or real economic value
 - Liked firms that sell below liquidation value



Characteristics of Value Firms

■ Measures


- **Price to Book:** Companies with low Price to Book ratios are value stocks
- **Price to Earnings ratio:** Companies with low Price to Earnings ratios are considered value stocks.
- **Price to Sales ratio:** Companies with low Price to Sales ratios are considered attractive because they may have potential for large future price gains.
- **Price to Cash flow:** Low Price to Cash Flow ratios firms are value companies.



Warren Buffett: Current leader of the value investing strategy

10 lessons from Warren Buffett

1. Better to buy a wonderful company at a fair price than a fair company at a wonderful price.
2. When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that survives.
3. Management does better by avoiding dragons, not slaying them.
4. Like Newton's law of motion, an institution will resist any change in its current direction.
5. Corporate projects will materialize to soak up available funds.

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6. Cravings of the leader, however foolish, will be quickly supported by detailed studies prepared by the troops.
 7. The behavior of peer companies will be mindlessly imitated.
 8. It is not a sin to miss a business opportunity outside one's area of expertise.
 9. If your actions are sensible, you are certain to get good results.
 10. Do not join with managers who lack admirable qualities, no matter how attractive the prospects of their business.

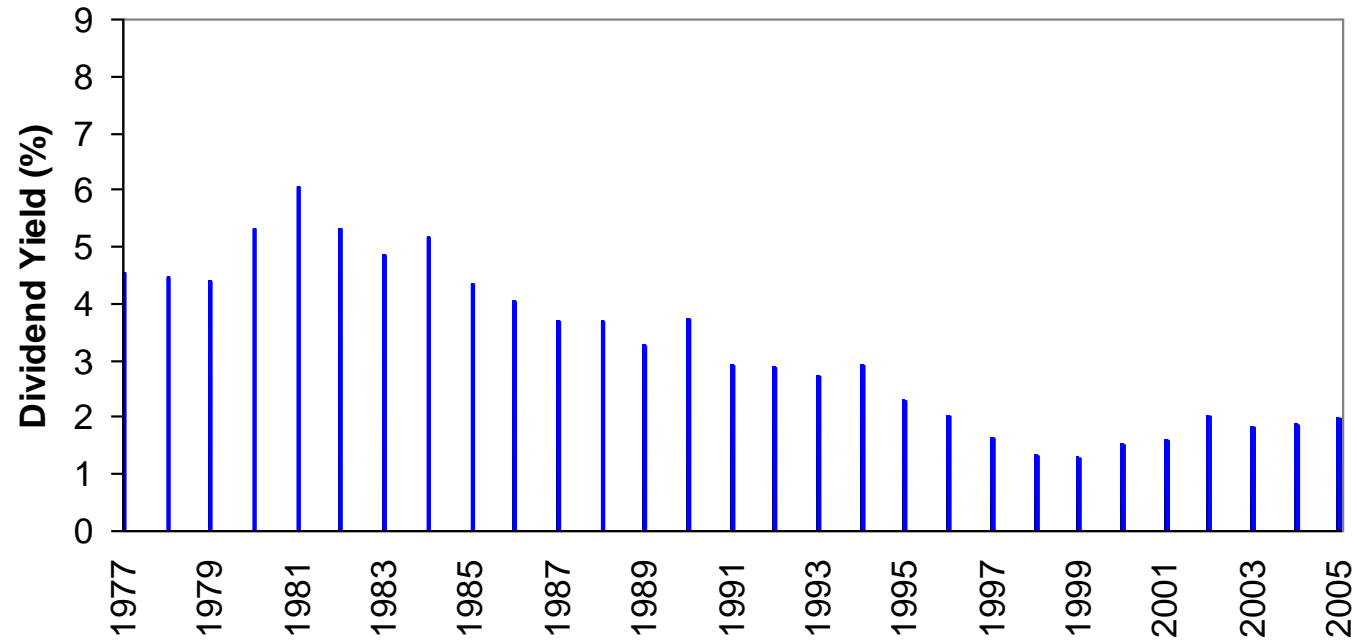




Dividends: An Important Part of Total Return from Value Firms

- Dividends mitigate risks—bird in hand theory
- Dividend growth
 - Dividends give more stable income streams than bonds.
 - Dividends grow faster than inflation over time.
 - Dividend yields have decreased over the last two decades.
- Valuable indicator of corporate health

S&P 500 Index





Finding Value Stocks

Common Criteria for Value Stocks part 1

- Ample cash reserves.
- Ample free cash flow to fund necessary investment
- Conservative financial structure
- Conservative issuance of common stock to managers and other employees (constant or falling number of shares outstanding).



Finding Value Stocks

- **Common Criteria for Value Stocks part 2**
- Low price-book ratio relative to the market and a company's own history
- Low price-cash flow ratio relative to the market and a company's own history
- Low price-earnings ratio relative to the market and a company's own history.
- Negative investor sentiment as reflected in poor financial ratings.
- Significant dividend income compared to market.

Value Investing

Advantages & Limitations

- Careful stock selection should limit downside risk
- Difficulty obtaining reliable and relevant information
- Not necessarily a buy-and-hold strategy—constant recycling of stocks through portfolio; constant research and vigilance
- Popular rules-of-thumb already factored into market?

