PART I

Different Approaches to the Investment Process

Chapter 1

What Is Value Investing?

> The difficulty lies not in the new ideas but in escaping from the old ones which ramify, for those who have been brought up as most of us have been, into every corner of our minds.
>
> —J. M. Keynes

Value investing is different from other kinds of investing. It is wholly unrelated to technical and chartist analyses. The underlying approaches to and goals of value investing differ quite materially from those used in academic finance under the rubrics of the *efficient market hypothesis* (EMH) and *efficient portfolio theory (EPT),* from those that are part of fundamental analysis as described in the various editions of *Security Analysis* by Benjamin Graham, David Dodd, and Sidney Cottle, popularly known as Graham and Dodd, and from those that seem to be the lifeblood of security analysis as practiced by conventional money managers and by research analysts employed by brokers / dealers. These fundamental differences are based on seven characteristics:

• Value investing uses a balanced approach to analysis so that there is no *a priori* primacy given to any one factor in an appraisal. In accounting terms, value investing treats every accounting number as being

as important as any other number, with each number being derived from, a function of, and modified by all other accounting numbers. Businesses are examined as integrated wholes. The quality and quantity of resources existing in a business and the long-term wealth-creation potentials of a business are each consequential factors in value investing, and each factor is related integrally to the other. If future wealth creation, in the forms of increased operating profits, increased cash flows, or enhanced underlying takeover values, cannot be created out of the present existence of high-quality assets and high-quantity assets, then either those assets never existed in the first place or what assets did exist were mismanaged. If future earnings or cash flows do not create wealth (i.e., resources for the company, its shareholders, or both), then those earnings were fictitious to begin with.

In contrast to value investing's three-pronged approach, the approaches used by academic finance, Graham and Dodd, and conventional money managers give primacy to forecasting future flows, whether those flows are cash flows, reported earnings, adjusted earnings, or all three in valuation. Other accounting figures, especially balance sheet data, are correspondingly downweighted as increased significance is placed on estimated future flows.

- **In value investing, the essential goal is to value a business or the workout potential for credits issued by troubled companies.** In the other disciplines, the goal is to forecast the prices at which a security will sell in markets populated by outside passive minority investors (OPMIs). Business value may be one factor to consider in forecasting market prices for securities, but it is rarely, if ever, the sole factor and is frequently an unimportant factor.
- **In value investing, equity holdings are viewed as permanent or semipermanent commitments, subject only to a risk arbitrage exception.** The risk arbitrage exception exists when there are relatively determinant workouts in relatively determinant periods of time, such as when there has been a publicly announced merger transaction. In the other disciplines, equity investments are viewed as trading vehicles because of the importance placed on near-term price performance in markets.
- **In value investing, macrofactors such as the level of stock averages (e.g., the Dow-Jones Industrials), forecasts of interest rates, or the gross domestic product (GDP) are ignored.** The emphasis is strictly on microfactors that specifically will affect a company over the

long term. In the other disciplines, the first factors to be considered usually are macrofactors.

- In value investing, as part of a balanced approach, businesses are viewed as both going concerns and as resource converters, deploying and redeploying their asset bases and liabilities into new areas including mergers and acquisitions, changes in control, massive refinancings, initial public offerings (IPOs), and leveraged buyouts (LBOs). The tendency in other disciplines is to view companies as strict going concerns engaged wholly in day-to-day operations in specific industries financed as they have typically been financed and managed as they typically have been managed.
- In value investing, corporate analysis is viewed as something separate and distinct from market analysis. In other disciplines, corporate analysis and market analysis are almost always integrated with each other. In value investing, a price decline for a security in the absence of any corporate permanent impairment of capital is viewed as a temporary phenomenon. In the other disciplines, a price decline is viewed as a loss of value.
- In value investing, the analyst is extremely price conscious in making judgments about the attractiveness of a security. In other disciplines, the strong tendency is to be outlook conscious rather than price conscious. Conventional asset allocators make investments on the basis of views about general or specific outlooks. In value investing, asset allocations are driven by price as related to the three factors inherent in a company: quality of resources, quantity of resources, and long-term wealth-creation potential.

The tools of value investing seem commonplace and important throughout the industrialized world, used not only by deal makers in the financial community but also by most private businesses for the analysis and financing of enterprises; yet those tools are largely ignored or deemed unimportant when OPMIs invest in publicly traded common stocks. Virtually all investment literature—whether written about trading systems, written in an academic context, or written as fundamental analysis as propounded by Graham and Dodd and their followers—is directed toward OPMIs. It seems as if virtually all business television shows and newspaper articles are directed toward a special kind of OPMI—"the average investor." On Wall Street, value investing seems very much to be a

minority approach restricted to investors trafficking in corporate control; but on Main Street, where most businesses are privately owned, it appears to be the majority approach.

Value investing entails buying what is safe and cheap. *What is* refers to the use of analytic techniques that concentrate on the known situation of a company—the quality and quantity of resources in a company, with little or no concentration on forecasts of relatively near term flows (say, over the next 12 months). *Safe* refers to the survivability of a business as a business without any reference whatsoever to price volatility of the securities issued by that business. Safety is measured mostly by strong financial positions; by the quality of resources, if the investor is interested in such junior securities as common stocks; by strong covenant protections; and by reasonable quantitative characteristics in terms of asset coverage or earnings coverage, or both, if the investor is interested in owning corporate debt. *Cheap* means an acquisition price for a common stock that appears to represent a substantial discount from what the common stock would be worth were the company a private business or a takeover candidate. *Cheap,* in the case of a debt instrument, means an estimated yield-to-maturity, or yield-to-workout, that is at least 500 basis points (a basis point, or bip, is $^1/_{100}$ of 1% or .0001) greater than could be obtained from a credit instrument bearing about the same level of ultimate credit risk.

In November 1998, Toyoda Automatic Loom Works, Ltd. common stock, listed on the Tokyo Stock Exchange, appeared to be a good example of a common stock that was safe and cheap based on "what is" because the company was well financed and represented a way of buying into the common stock of Toyota Motor, a blue-chip automotive manufacturer at a discount of perhaps 35% to 40%. Toyoda common was trading at about 2,300 yen per share, or about $16.5–$17 U.S. dollars. Its adjusted balance sheet, expressed in U.S. dollars, was as shown in Table 1-1.

In November and December 1955, Kmart senior debentures and trade claims seemed to be good examples of credit instruments that were safe and cheap based on "what is." The Kmart situation is discussed in detail in Chapter 14. On average, these senior issues traded in public and private markets at prices averaging around $74. These instruments had average yields-to-maturity of around 18% in a market in which BB industrial credits were trading at yields-to-maturity of around 9% and BBB

Table 1-1. Balance Sheet for Toyoda Automatic Loom Works Ltd. (Adjusted NAV in $000s)

		6.0×	8.0×	Per Toyoda Share*	
Operating Income	$251,570	$1,509,420	$2,012,560		
Less: nonconvertible funded debt		259,917	259,917		
		1,249,503	1,752,643	$3.97	$5.56
192,725 shares Toyota Motor Common @ $25/share		4,818,125	4,818,125	15.30	15.30
Remaining portfolio of marketable securities at market 11/13/98		1,990,129	1,990,129	6.32	6.32
NAV appraising Toyoda as a closed-end investment company		8,057,757	8,560,897	$25.58	$27.18
Discount from NAV at market price of $16.59 for Toyoda Common				35.1%	38.9%

*Adjusted shares outstanding, 315,000; Toyoda Auto Loom share price @ 11/13/98, $16.59; exchange rate, 122.65 yen to the dollar.

obligations were trading at yields to maturity of around 8%. BBB is the lowest grade credit which Standard & Poor's, as a rating agency, defines as Investment Grade. Standard & Poor's defines a BBB credit as follows: "An obligation rated BBB exhibits adequate protection parameters. However adverse economic conditions or charging circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation (as compared with credits rated AAA, AA, or A). Obligations rated BB, B, CCC, CC, and C are regarded as having significant speculative characteristics." BB is the highest grade obligation to be characterized as speculative.

It was problematic at the time as to whether Kmart would have to seek relief under Chapter 11 of the U.S. Bankruptcy Code. If Kmart did seek Chapter 11 relief, all cash service on the Kmart debt would cease. I concluded, however, that the odds were overwhelmingly that if Kmart ever did enter Chapter 11, the workout values for these Kmart instruments in a reorganization would be at least $100 or more likely $100 plus accrued interest. This confidence in the ultimate workout was based, in great part, on the seniority enjoyed by these debentures and trade claims.

Although no two value investors will use precisely the same investment techniques among themselves, all value analysts focus on analytic variables quite different from those emphasized in all the current literature on security analysis or corporate finance that is directed toward OPMIs. This other body of literature encompasses academic writings about the efficient market hypothesis (EMH), efficient portfolio theory (EPT), Graham and Dodd fundamentalism, and newer offshoots of modern capital theory (MCT) such as new finance.[1] Furthermore, value investing is removed completely from all technical chartist literature, the outpouring of works purporting to predict and explain price levels for general markets or for specific securities traded in markets popular with OPMIs.

Value investing becomes increasingly useful for those who also understand academic theory, as expounded in the EMH and EPT, and for those who also understand traditional fundamental analysis, as described in the various writings of Graham and Dodd. For example, the EMH is useful for securities traders whose sole goal is to consistently maximize a total return on a risk-adjusted basis (i.e., all the time). Graham and Dodd note important caveats for those who do not know much about the companies whose securities they hold or are considering acquiring. Value investing, in comparison, revolves around obtaining a fairly deep understanding of either the business, the securities issued by that business, or both. Importantly, the value analyst, as part of the analytic process, tries to understand where other market participants are coming from, why these others do what they do, and why they say what they say.

[1] See the book *The New Finance: The Case Against Efficient Markets* by Robert A. Haugen (Prentice Hall, 1995).

Graham and Dodd, in their 1962 edition of *Security Analysis,* describe the difference in analytic approaches in OPMI markets compared with those in private business markets:

> Security analysts … should reflect fully on the rather startling truth that as long as a business remains a *private* corporation or partnership the net asset value appearing on the balance sheet is likely to constitute the point of departure for determining what the enterprise is "worth." But once it makes its appearance as a "publicly held company"—even though the shares distributed to the public constitute only a small part of the total—the net-worth figure seems to lose virtually all its significance. "Value" then becomes dependent almost exclusively on the expected future earnings (p. 551).

Graham and Dodd are insightful in pointing to the strong tendency to use different variables, or to weight the same variables quite differently, when valuing a private business versus estimating prices at which OPMI common stocks might trade. Value investors who seek control of corporations (and corporate processes) actively arbitrage these differences between corporate values and OPMI market prices. The arbitrage tools they use are described in Part III of this book, in which there are brief discussions about restructuring troubled companies, mergers and acquisitions (M&As), contests for control, LBOs, management buyouts (MBOs), and IPOs.

A value investor who is a passive rather than an active control investor is conscious of the discrepancies in valuations between a private business value and an OPMI common stock price. In value investing, it is assumed that sooner or later there will be an arbitrage between OPMI prices and private business, or takeover, values and that an LBO or M&A will occur at some substantial premium over OPMI market prices. According to Graham and Dodd fundamentalism and the EMH, on the other hand, the underlying assumption seems to be that in the vast majority of cases, the company whose common stock is traded in the OPMI market will continue indefinitely to be a going concern, engaged in the operations in which it always has been engaged, managed the way it always has been managed, owned pretty much the way it has always been owned, and financed the way it always has been financed.

OPMIs were defined in 1979 in *The Aggressive Conservative Investor,* by Martin J. Whitman and Martin Shubik, as any participants in a securi-

ties market, whether individual or institutional, who can be distinguished from others in two respects:

> First, individually they have no control or influence over the businesses whose securities they hold or contemplate holding. Second, they do not have access to information other than that which is generally available to the public.

It is logical—efficient—that net asset value be weighted more heavily in a private business analysis than in an OPMI analysis. Control people influence how corporate assets are used and financed. OPMIs have no influence; for them, there are no opportunities to influence how assets might be employed or redeployed. Also, in an OPMI market, near-term prices of solvent corporations are bound to be much more influenced by reported earnings than by changes in reported asset values.

The best of the value analysts—including Warren Buffett, Carl Icahn, Ted Forstmann, Henry Kravis, Ron Perelman, and Richard Rainwater—worry about business values and business dynamics. Admittedly, these superior investors are all basically control activists rather than OPMIs. Nonetheless, their basic approach seems significant for OPMIs. In their own investment commitments, these superior investors seem to care not one whit about predicting a security's price when they have no influence in determining that price. Markets are not something they predict; markets are something of which they take advantage. As such, they carry a lot less analytic baggage than most OPMIs and a lot less analytic baggage than all who write about the efficient market hypothesis, Graham and Dodd fundamentalism, and the new finance.

Understanding value investing approaches and techniques ought to be extremely helpful in enabling OPMI securities investors to be successful. Indeed, value investing seems to be one of the more promising approaches for OPMIs who, although they are passive, seek to earn excess returns both on average and over the long term.

Admittedly, the returns to be earned from being successful at control investing probably are larger than they normally could be from OPMI investing, even though both types follow a value investing approach. There are many inherent advantages to control investing; even so, there are quite a number of inherent advantages to OPMI investing. Obviously, most investors will never become control investors, but anyone with a few thousand dollars or a self-directed 401(k) plan can become an OPMI.

Advantages to Control Investing

At the risk of overgeneralizing, the inherent advantages of control investing, especially for those who actually achieve elements of control, might be summarized as follows:

- Control investing creates edges so that a control person can obtain additional rewards over and above those that attach directly to securities ownership. These edges have three components:
  1. Something off the top (SOTT), or salaries, perks options, fees, expense reimbursements, and luxurious travel and entertainment perks
  2. An ability to finance transactions and processes on a highly attractive basis (i.e., an ability to use other people's money [OPM])
  3. An ability to create advantageous tax situations (i.e., tax shelters [TSs])
- In exploring investment opportunities in which control situations exist, security buyers frequently have the ability, the resources, and the time to conduct in depth due-diligence investigations, which can be far more comprehensive than would be possible relying solely on public records. (A notable exception, though, tends to be hostile takeovers, in which potential acquirers may be stopped from using inside information.)
- Control investing allows investors to obtain influence, control, or both over corporate processes, operations, and investments. One of the things this gives the control investor is opportunities to create values by changing the way assets are used or owned and by recapitalizing businesses.
- Control investing allows investors to obtain control over timing on a long-term basis so that they decide when to take advantage of favorable OPMI market conditions, whether to consummate an IPO, a going private, a massive refinancing of debt, or a merger in which common stock is issued as all or part of the merger consideration.
- Control investing allows investors to obtain self-protection, almost always with the unfettered ability to finance that self-protection by using the corporate treasury.
- Control investing allows investors to obtain the power to reward other professionals (e.g., investment bankers, attorneys, accountants),

to withhold favors or advantageous treatment from people dealing with the corporation or seeking to deal with the corporation, or both.

Advantages of Investing as an Outside Passive Minority Investor

Despite the advantages to control investing, there are a number of inherent advantages for OPMIs who follow the same basic analytic precepts of value investing that are followed by control investors. Again, at the risk of overgeneralizing, OPMIs can experience the following advantages that promise not only a margin of safety on the downside but also the prospect of excess long-term returns on the upside.

- Outside passive minority investors can acquire securities at ultralow prices. Frequently, prices in OPMI markets are only small fractions of what corporations are worth as measured by business values. OPMI market prices tend to be much lower—and also much higher—than prices that would be arrived at in arm's-length negotiations between and among informed business people. For example, in September 1998, it was possible to acquire the common stocks of leading semiconductor equipment manufacturers at prices far cheaper than would be available for first-stage venture capitalists financing high-tech enterprises *de novo.* FSI International common, Silicon Valley Group common, and Speedfam common all had cash holdings equal to at least 95% of book liabilities and were selling at discounts from tangible net asset values and at no more than seven times the peak earnings that had been achieved in the recent past before the industry was hit by a severe depression in 1997.
- In acquiring equities, OPMIs can restrict investments to high-quality, well-financed companies, a luxury frequently unavailable for control investors. In acquiring credit instruments, OPMIs can restrict their investments to senior instruments containing strong protective covenants in which pricing reflects much above average yields-to-maturity, or yields-to-event.
- For OPMIs, finding attractive investment opportunities is much easier and a much less competitive activity using value investing techniques than is the case for typical OPMIs. The typical value investor is among the

small minority of OPMIs concentrating on a buy-and-hold strategy emphasizing quality and quantity of resources in a business as well as long-term outlooks. Most OPMIs are instead vitally interested in near-term outlooks, especially reported earnings per share, and predicting levels of securities prices. In September 1998, for example, an investor could acquire the common stocks of extremely well financed Japanese non–life insurance companies, such as Tokio Marine & Fire Insurance Company, Ltd., at prices representing 30% to 75% discounts from a net asset value that consisted almost solely of marketable securities and performing loans. Few OPMIs would have been interested in these securities, because the near-term outlooks for reported earnings were poor and, over the longer term, insurance operations were bound to face increasing competition.

- Although the protections available for OPMIs are nowhere near as valuable as control investors' ability to self-protect in many instances, OPMIs obtain regulatory protections from governments, self-regulatory organizations, and the private bar, which will propagate class-action and derivative lawsuits on behalf of OPMIs and the company itself, respectively. Informed OPMIs using value investing techniques obtain considerable ability to self-protect through regulator-required disclosures, fair trading markets, and a modicum of reasonable behavior by fiduciaries and quasifiduciaries.
- Outside passive minority investors obtain liquidity and marketability for their investments. This means, among other things, that it tends to be a lot easier for OPMIs than for control investors to undo mistakes.
- Analysis of given situations tends to be a lot easier for OPMIs than for control investors when both use value investing techniques. The OPMI need only identify attractive securities from a price-to-value point of view. The control investor has to identify not only attractive situations but also doable deals (i.e., situations where elements of control might be available). It tends to be a lot easier to identify attractive securities than to identify doable, attractive deals.

Another way of understanding value investing—whether undertaken to achieve elements of control, to be purely passive, or to be undecided about whether an ultimate objective is control or sale to an OPMI market—is to analyze each situation as if investors were to put up $100 million or more of their own funds that will remain committed to the

security on a permanent or semipermanent basis. The reality, however, is that many using value investing techniques are not permanent or semipermanent investors even though they analyze as if they were. Shorter-term players who use value investing techniques include the following:

- **Risk arbitrageurs, who make investments on the basis of the prospect that there will be reasonably determinant workouts in reasonably determinant periods of time.** Risk arbitrages usually involve deals in which there has been a public announcement. One example of a risk arbitrage was the announced common stock for common stock merger between KLA Instruments Corporation and Tencor Instruments. Just prior to the January 1997 announcement of the one-for-one common stock exchange, KLA common was selling at $40\,^{7}/_{8}$ and Tencor common was selling at $30\,^{1}/_{2}$. The risk arbitrage subsequent to the announcement involved either acquiring Tencor common at a price reflecting a discount from the price of KLA common or a combination of buying Tencor common at the discount price and selling short KLA common at a premium price relative to the price of Tencor common. On consummation of the merger, the arbitrageur would deliver, say, 100,000 shares of Tencor common purchased at 35 to cover a short position in KLA common in which the arbitrageur had sold 100,000 shares at, say, 39. The 4-point spread between 35 and 39 would have resulted in the arbitrageur's realizing a $400,000 profit before transaction costs and taxes.
- **Creditors holding nonperforming loans.** The restructuring process here, whether out-of-court or in Chapter 11, tends to be much like risk arbitrage because the analysis usually involves ascertaining what reasonably determinant workouts will be in reasonably determinant periods of time.

The Basic Concepts of Value Investing

Modern value investing is based on a number of basic concepts that differ drastically from those underlying the EMH and the theories of Graham and Dodd:

- Information can be used in a superior manner.
- Constituencies in financial dealings always involve both communities of interest and conflicts of interest.
- No market participant is deemed crazy or stupid.
- Value is a dynamic concept.
- Market price is not something to predict but something of which to take advantage.
- There is no general risk—only specific risk.
- The devil is in the details, not in general laws.
- Understanding institutions and infrastructures is a necessity.
- Understanding the roles of governing bodies is key.
- Flexibility rules.
- Knowing the elements of attractive pricing is critical.
- Value investors know more than does the OPMI market about matters that count.
- Earning excess returns is the norm in an efficient market.
- Control securities are essentially a different commodity than noncontrol securities.
- Most of the time, capitalization is not determined by equity investors' needs or desires.
- Diversification is a nonstarter in most markets.
- Every investment has something wrong with it.

Use of Information

As is pointed out *ad finitum* in EMH literature, OPMIs do not, as a rule, have access to superior information. This lack of access is immaterial, however, in value investing. The key in value investing is for the passive investor to use the available information in a superior manner. The value analyst, for example, will, in analyzing an equity security, attach great weight to the strength of an issuer's financial position and / or the ability of the issuer to obtain access to capital markets on an attractive basis. By contrast, those focused on EMH considerations would pretty much ignore a corporation's financial position and would instead tend to find key information in the amount by which actual reported earnings for a quar-

terly period exceeded, equaled, or fell short of consensus forecasts. Value investing's focus on financial position may be a superior use of available information compared with EMH considerations, where the emphasis is on forecasting future flows—a primacy of the income account approach. Emphasizing flows seems a far cry from using available information in a superior manner most of the time. For example, it was possible to invest in Forest City Enterprises class A common stock in 1991 at around $20 per share, even though the company's annual report stated that the appraised value of this investment builder's income-producing properties alone, virtually all financed with nonrecourse debt, exceeded $80 per share. At the time, Forest City, operated in the ultradepressed real estate industry and was reporting accounting losses based on generally accepted accounting principles (GAAP). Charges for depreciation and amortization were being deducted from profits for accounting purposes while, for economic purposes, property values were probably increasing. Focusing on appraised values rather than accounting earnings for Forest City seemed a good example of using the available information in a superior manner.

In value investing, the quality of information is judged by an estimate of how that information might affect corporate values, corporate dynamics, or the rights and privileges attached to various securities. In other types of investing, especially EMH, the test of the value of information is strictly an estimate of how that information might affect immediate market prices in the OPMI market. This is logical for the EMH, which is based solely on studies of securities prices and essentially excludes any study of corporate values not strictly related to market prices.

The differences in information requirements for value investing compared with those for typical OPMI investing seem striking. They might be generally summarized as in Table 1-2.

In value investing, the importance of a particular item of information depends on context. For example, in the other disciplines, except Graham and Dodd, quarterly reported earnings per share are almost always highly important, but in value investing, they are almost never important. Quarterly earnings do become important in value investing, however, insofar as they become an indication of a permanent impairment of corporate value, something more likely to be the case when a company is not well financed, or the quarterly results are evidence that the company is losing competitive position, or both.

Table 1-2. Information Usage: Value Investing versus Typical Passive Investing

Important in Value Investing	Important to the Typical OPMI
Long-term outlook—over a business cycle	Industry identification
	Earnings per share versus consensus forecasts
Ability to finance a transaction	Current P : E ratios
Each element in the accounting cycle	Primacy of the income account
What the accounting numbers mean rather than what the accounting numbers are (except when seeking to use the OPMI market)	Historical P : E ratios
	Reported earnings, unadjusted
	Comparative analysis
	Dividends—shareholder distributions
Benefits of control	Long-term earnings record
Quality and quantity of resources in a business	Immediate macro-outlook
	Long-term macroconsiderations
Comparative analysis is a limited tool	Equilibrium price
Doability tends to be a key variable	Technical factors
No equilibrium price for all markets	Trend of earnings
Change of control factors	Sponsorship
Securities law and regulation	Return on equity and assets
Income tax code	

OPMI = outside passive minority investor; P : E = price-to-earnings.

Constituencies in Financial Dealings Always Involve Both Communities of Interest and Conflicts of Interest

The relationships between and among the various constituencies involved in financial dealings always involve both communities of interest and conflicts of interest. There are no *a priori* real-world reasons for assuming that any one group's interests take precedence over other groups' interests in all contexts. It seems utterly unrealistic to assume that managements work exclusively in the best interests of stockholders. Each constituency—the company *qua* the company, management, short-term traders, buy-and-hold investors, senior creditors, trade creditors, junior

creditors, landlords, control shareholders, OPMIs, labor unions, governments, communities, financial professionals (investment bankers, attorneys, accountants, etc.)—is separate and has its own agendas combining communities of interest and conflicts of interest with each of the other constituencies.

Since the 1970s, there has been a significant, seemingly inexorable trend toward entrenching management in office that has become embodied in state law, the primary province for corporate governance. This gives rise to conflicts of interest between managements and OPMIs, especially OPMIs seeking to maximize the near-term price performance of their securities portfolios. Managements do not succumb to takeover bids just because they represent an otherwise unobtainable premium over OPMI market prices. (Take, for example, the April 1997 buyout offer for ITT by Hilton Hotels.) Most managements (with minor exceptions), however, feel a community of interest with OPMIs in terms of desiring reasonable near-term performance in OPMI markets for the common stocks issued by the companies they manage.

Sometimes there are partial consolidations among constituencies where communities of interest predominate; for example, all classes of creditors believe they will be harmed if cash distributions are made by the company to equity holders. Sometimes the previously consolidated group will be dominated by conflicts of interest, so each constituency in this situation is best viewed as a nonconsolidated stand-alone; for example, the various creditors in the previous sentence may argue about reorganization plans for a troubled issuer and how assets are to be distributed in a reorganization to different classes of creditors. (Take, for example, the April 1998 contretemps between the secured lenders and the junior lenders in connection with the Marvel Comics Chapter 11 case.)

In value investing, the company *qua* the company is almost always a unique constituency. Each other constituency tends to benefit when the company is feasible (i.e., healthy and strong). At the same time, each other constituency tends to benefit when it obtains distributions from the company that may detract from feasibility (e.g., management compensation or cash distributions to shareholders that do not enhance a company's future access to capital markets). Also, as a practical matter, in certain situations, such as Chapter 11 reorganizations, the company is unrepresented by professionals in a confrontational process. Attorneys and

investment bankers retained by companies in Chapter 11 almost always have a first loyalty to the management or control group that hired them and not to the company per se. In Chapter 11 reorganizations, there are frequently important conflicts between a company's quest for feasibility on the one hand and management's quest for compensation and entrenchment and a creditor's quest for cash and secured cash-pay instruments on the other hand.

An important thing to realize in value investing is that despite frequent use of terms indicating otherwise, the company is not the management; management may not be the control stockholders; and neither the company, management, nor control stockholders are OPMIs.

No Market Participant Is Assumed to Be Crazy or Stupid

Although this book presents value investing as a preferred technique for many investors, this by no means implies that other investment approaches—technical chartist approaches, momentum investing, IPO investing, EMH approaches, and Graham and Dodd approaches—are invalid. These approaches are only invalid insofar as their proponents believe they have discovered the Holy Grail, the one universal explanation of Wall Street and investing. Many in academic finance seem inclined to believe that they are expounding eternal truths and universally acceptable general laws.

The successful promoter using value investing understands why others do what they do, then takes advantage of it. For example, if you want to be involved in promoting LBOs, it is important to understand why prices in OPMI markets are—and ought to be—different from what an LBO buyer can afford to pay for a business. The OPMI price is not crazy for participants in OPMI markets; it is just not an appropriate value for the LBO market, where prices tend to be considerably higher than they are in many sectors of the OPMI market. Similarly, the venture capitalist realizes that pricing for IPO market purposes is, as a rule, many times higher than prices that would be paid for private companies if they were to remain private companies. For value investing purposes, the basic assumption is that pricing in IPO markets and the very different pricing in private markets are both quite rational within their own contexts.

Value investing is an unsuitable approach in several contexts. It would be crazy or stupid to become a value investor who ignores rather completely day-to-day OPMI market prices:

- when a passive investor operates with borrowed money and the collateral value of the borrowings is determined by daily OPMI pricing (i.e., marks to market). Such an investor ought to focus in great part on market risks (i.e., possible day-to-day changes in market prices) rather than on investment risk (i.e., long-term underlying corporate values).
- where a money manager's job or compensation is determined by near-term performance in OPMI markets.
- when clients demand immediate OPMI performance.
- when the money manager or the investor is untrained in value investing analytic techniques and is unable to make meaningful judgments about corporate values independent of OPMI market prices.
- when the investor is in the OPMI market strictly to gamble, with the OPMI market satisfying the participant's needs to play in a casino.
- when the investor is a short-run trader not involved in risk arbitrage.

Value Is a Dynamic Concept

Corporate values are continually changing. In good businesses that do not make massive distributions to shareholders, values tend to increase on a reasonably regular basis. These increases in underlying business value may have no particular relationship to OPMI market prices but rather may reflect improvements in operations, financial strength, and basic earning power. Liberty Financial, a life insurance and asset management company, had $48 billion of assets under management (AUM) on December 31, 1996, up from a *pro forma* figure of around $40 billion 2 years earlier. There seems to be a ready market for AUM at 2% to 4% of AUM. Liberty Financial obviously created values between 1994 and 1996, even though these were not necessarily reflected in OPMI prices or GAAP-determined net asset values. At 2% of AUM, the $8 billion increase in AUM from $40 billion to $48 billion would have a sales value of $160 million; at 3% of AUM, the increase in sales value would have been $240 million.

Corporate values are also created by macromarket conditions even in situations in which the OPMI market consensus is strictly bearish. In April 1997, for example, there seemed to be an OPMI consensus that high interest rates and inflation were negative factors universally. As a matter of fact, a high interest rate and a modest-to-high inflation environment probably would accelerate the creation of corporate values for a number of companies.

Even though high interest rates would tend to reduce the value of a business to be acquired by the use of acquisition debt, it would very much tend to increase future earnings and value for businesses whose assets consist of material amounts of interest bearing obligations and whose liabilities are largely free of interest-bearing obligations. The future earnings benefits would be especially large for companies whose portfolios of performing loans are expanding in size. Financial Security Assurance Holdings, known generally as FSA—a financial insurer—is just such a company. At December 31, 1996, about two thirds of its assets were in bonds, on which it earned about 6.3%. Any increase in interest rates would result in increases in the company's future net investment income.

Inflation would tend to reduce the quality of earnings of a capital-intensive company such as Cummins Engine because depreciation charges against income tend to become inadequate as replacement reserves in an inflationary environment. On the other hand, inflation tends to make it more expensive for new entrants to come into an industry, giving existing entities, such as Cummins Engine, insulation against new competition. Further, a well-financed company may find itself in a position to make attractive acquisitions insofar as inflationary pressures result in restraints on the operations of poorly financed firms. Finally, inflation probably increases takeover prices and makes takeovers a more common occurrence, as aggressive companies conclude that it is cheaper to *buy* at premiums over OPMI market prices than to *make* by entering an industry *de novo.*

Market Price Is Not Something to Predict but Something of Which to Take Advantage

In value investing, OPMI market price tends to be a realization figure, not a valuation figure. As a realization figure, an OPMI market price

serves as an indication of the prices at which you ought to be able to buy or sell a security, assuming you want to buy or sell. Market price, as a valuation figure, is never a universally accepted valuation figure (i.e., a value measurement valid for all, or even most, contexts—OPMI market, LBO market, or IPO market).

Value investing perceives the existence of a long-term arbitrage between OPMI market prices and business values. When OPMI market prices are low relative to business value, publicly traded shares tend to be acquired by activists in hostile takeovers, LBOs, and going-privates. (Take, for example, the 1997 acquisition of Destec Energy for cash at a 60% premium over OPMI market price for Destec common.) When OPMI market prices are high relative to business values, common stocks tend to be issued to the public in IPOs and M&As, where the currency used for the M&A is common stock, in whole or in part (e.g., the buoyant IPO market that existed from 1995 through 1997).

There Is No General Risk—Only Specific Risk

In value investing, the word *risk* is always modified by an adjective. There is no general risk. There is market risk, investment risk, interest rate risk, inflation risk, failure to match maturities risk, securities fraud risk, excessive promoters' compensation risk, and so on. In value analysis, the tendency is to guard against investment risk, the prospect that things will go wrong for the business in which the activist has invested. Market risk, the prospect for price fluctuations in OPMI markets, is usually ignored. Put otherwise, the value analyst, in examining the risks in an investment, worries about permanent impairments of capital but not about unrealized market losses or a reduction in the amount of unrealized market profits.

The analysis of Kmart Debentures and Kmart Trade Claims (together, Kmart Credits) at the end of 1995 serves as a good example of the difference between investment risk and market risk. In late 1995, it seemed impossible to predict whether Kmart would seek reorganization under Chapter 11 of the U.S. bankruptcy code. It seemed a certainty that if Chapter 11 relief were sought, interest payments would stop and there would be no 18% yield-to-maturity. Further, the probability

seemed to be that Kmart Credits would sell in the OPMI market at dollar prices well below the existing prices of around $74, if for no other reason than that the holders of debentures relying on interest income, which would no longer be paid, would dump their holdings by immediate sale into the OPMI market. Thus, Kmart Credits seemed to carry a high degree of market risk.

Despite the existence of market risk, however, Kmart Credits seemed to carry little or no investment risk. If Kmart did not file in Chapter 11, Kmart Credits would continue to be performing loans, affording as yield-to-maturity 700 to 900 bips above comparable credits. Furthermore, it appeared that if Kmart were to file for Chapter 11 relief, the company would be readily reorganizeable, and since Kmart Credits were, in effect, the most senior issue of Kmart, the holders of Kmart Credits seemed bound to receive, in a Chapter 11 reorganization, a value in new Kmart securities of not less than 100—more likely 100-plus accrued post-Chapter 11 interest.

Investment risk for a security has three general components in value investing:

- Quality of the issuer
- Terms of the issue
- Price of the issue

When the focus is on quality of the issuer and terms of the issue only, as is a basic precept of academic finance, a risk-to-reward ratio comes into existence. For academic finance, the higher the quality of the issuer and the more senior the terms of the issue, the less risk of loss the investor is taking. Also, the higher the quality of the issuer and the more senior the terms of the issue, the less the rewards are likely to be for the investor, thus the risk-to-reward ratio.

For academic finance, the price of the issue as it trades in OPMI markets reflects a universal price equilibrium; that is, it is the correct price for all purposes and all participants. Insofar as the price of the issue is too high or too low, however, no risk-to-reward ratio exists; it cannot exist. Suppose the price is too low. That means that the issue carries a reduced risk of loss and an enhanced potential for reward. In value investing, there usually is no risk-to-reward ratio simply because price of the issue be-

comes so important that it outweighs the risk-to-reward equation that appears to be valid insofar as an analysis is based on an assumption of the existence of a price equilibrium, so that the only factors to weigh are quality of the issuer and the terms of the issue.

When equity securities and nonperforming credit instruments based on forecasted future flows are analyzed, the appropriate discount rate encompasses three elements:

- Time value of money
- The risk that actual flows will be less than forecast
- The potential that actual flows will be better than forecast

When performing loans that sell at or near their principal amounts are analyzed, the appropriate discount rate reflects only two factors: the time value of money and the risk that actual flows will be less than forecast. From a credit risk point of view there are no material rewards for the holders of performing loans selling at prices close to the principal amount if actual flows turn out to be better than forecast; at best, the bondholder will be entitled only to the principal amount plus possibly a small call premium.

The Devil Is in the Details, Not in General Laws

Value investing entails a bottom-up approach, and ultimate investment decisions are governed by specifics, not general rules. For example, it is well demonstrated that buying new-issue IPOs across the board is a tough way to earn excess returns. This does not mean that the value investor never buys new issues. It does mean that value investors must be highly selective in acquiring new issues in OPMI markets. It also means that the overpricing of new issues, in general, ought to be an attractive arena for investors who do not choose to be OPMIs but rather seek to earn excess returns as venture capitalists, new-issue underwriters, or securities salespeople. Securities salespeople benefit by marketing IPO products because these products are exclusive, tend to be easy sells, and provide much above average compensation, certainly as compared with competing with discount brokers in the purchase and sale of securities in secondary markets.

Understanding Institutions and Infrastructures Is a Necessity

If you are to be successful at value investing, it is imperative that you understand the environment within which investing takes place. For value investing in the United States, you ought to be knowledgeable enough in three specific areas to at least be an intelligent client of knowledgeable professionals:

- Securities law and regulation
- Financial accounting
- Corporate income taxes

Other institutional areas in which it is useful to be knowledgeable are:

- Methods of operation for financial institutions
- Factors and processes involved in corporate control

including tools for the entrenchment of incumbents:

- Promoters' and professionals' compensations
- Capital structures
- Substantive characteristics of securities

Understanding the Roles of Governing Bodies Is Key

The various governing bodies in the United States play important roles in most investment processes, including:

- Taxing agency
- Provider of attractive finance
- Provider of direct subsidies
- Provider of infrastructures
- Securities regulator
- Regulator in other areas
- Provider of judicial systems

- Customer
- Competitor
- Provider of freebies (e.g., certain broadcast licenses)

Flexibility Rules

In the bottoms-up approach characteristic of value investing, no one approach is the correct one for all contexts. Take financial accounting, for example. It is the one tool with which analysts can obtain objective benchmarks essential to helping them reach conclusions. Normally, what the numbers *mean* for analysts is infinitely more important than what the numbers are *reported* to be. Applied Materials, a supplier of equipment to the semiconductor industry, expenses all of its very large annual expenditures for research, development, and engineering as charges to net income; in 1996, such charges amounted to 11.6% of net sales. In an economic sense, it ought to be argued that a portion of such expenditures for research, development, and engineering ought to be capitalized because their purpose is to create future earning power rather than to contribute to the maintenance of current earnings; thus, they are more in the nature of capital expenditures than current expenses. Applied Materials seems to be accounting quite conservatively. Most of Applied Materials' buy-and-hold shareholders care about what the numbers mean, not what the numbers are. Since Applied Materials has considerable surplus cash, expensing all research, development, and engineering does no harm to Applied Materials as a corporation. Assume, however, that instead of having surplus cash Applied Materials needed to raise capital and was seeking access to capital markets, especially OPMI markets for an IPO. It probably would be beneficial for the company and its stockholders in this instance if Applied Materials reported larger earnings per share, which would be achievable were a portion of research and development expenditures capitalized rather than expensed. In an IPO market, what the numbers *are*, especially the earnings per share number, tends to become a lot more important than what the numbers *mean*.

Value investing recognizes that most businesses are both strict going concerns engaged in day-to-day operations and resource conversion com-

panies engaged in asset and liability redeployments and changes in control. In going-concern analysis, the emphasis tends to be on the primacy of the income account—what future flows will be, whether cash flows or accounting earnings. In resource conversion analysis, the emphasis tends to be on the market value of the corporation's assets and the prospects that the corporation might have access to capital markets on a superattractive basis.

Flexibility, rather than general rules, are the order of the day in specific situations. Sometimes going-concern aspects should be emphasized. Sometimes resource conversion characteristics should be emphasized. It was pointed out above that if interest rates rise, future net investment income for FSA will be larger than otherwise would have been the case, a strong benefit in analyzing the company as a going concern. In contrast, if interest rates rise the current market value of the FSA portfolio of performing loans will decrease, a distinct negative in valuing the company and its common stock.

As part of flexibility, value investors recognize the trade-offs inherent in each situation, knowing that every number in financial accounting is derived from, modified by, and a function of other accounting numbers. For example, companies with strong financial positions in good times are sacrificing return on equity (ROE) compared with what ROE would be were assets employed more aggressively, were there more leverage in the capitalization, or were both situations the case. At the same time, increasing ROE probably means a trade-off with safety most of the time. Prediction of future earnings or cash flows in situations in which such futures are not contractually assured is subject to high degrees of error. Seeking to maximize ROE or economic value added (EVA) makes the consequences of overestimating future flows much more dire for companies, and probably their OPMI stockholders, than would be the case were maximizing ROE modified by reducing ROE through increasing the company's financial strength. Increasing financial strength means either financing with less debt and more equity, holding assets (e.g., cash) on which the returns might be modest, or both. Strong finances—and a resulting lower ROE than would otherwise be the case—also may mean that a management skilled in the acquisition arena has lots of "dry powder" with which to make attractive acquisitions in the future.

Knowing the Elements of Attractive Pricing Is Critical

For passive investors using value investing techniques, it is critical to have pricing parameters to determine whether a security is attractive enough to buy. In value investing, these parameters can differ, just as company characteristics differ. It would be hard for the case to be otherwise, especially because analysts have to make judgments in appraising management capabilities and the status of the three legs of the balanced approach: quality of resources, quantity of resources, and long-term wealth-creation power. Reasonable pricing parameters for OPMI investors can be seen as follows in selected industries:

- High-tech small-cap issues: Pay up to a 60% premium over net asset value, on the theory that this simulates pricing by a first-stage venture capitalist (e.g., the pricing for Silicon Valley Group common stock in August 1998).
- Community banks: For a well-capitalized institution, pay no more than 80% of book value (e.g., the 1995 pricing for Carver Federal Bank common stock).
- Income-producing real estate: Ignore book net asset value altogether; concentrate on appraisal values (e.g., the 1992 pricing for Forest City Enterprises class A common stock).

In value investing, credence is given to a wide scope of possible exit strategies, ranging from sale to an OPMI market to M&As to corporate liquidations.

Financial accounting is not cost accounting. Analysis of profit margins, especially among different companies, may be of only limited usefulness. This is almost always the case for securities holders, who have no access whatsoever to cost-accounting data or even long-form financials.

It frequently is easier to predict future flows by examining the quality and quantity of resources in a business rather than by extrapolating from the past earnings record. Neither tool need be used to the exclusion of the other, however.

Deal pricing is more than a function of a security's price. How much control buyers ought to be willing to pay depends a lot on how they are able to finance, the amount of promoters' and professionals' compensa-

tions that might be in the deal, and whether workouts are reasonably determinant within reasonable periods of time.

For control investors, there are many things to consider besides the all-in dollar price when contemplating an M&A, an LBO, or a hostile takeover. To summarize any contemplated transaction involves at least 11 general considerations:

- Pricing issues
- Securities law and regulation issues
- Income tax—and other tax—issues
- Other regulatory issues, such as antitrust laws, or specific agencies, such as banking regulators or the Federal Communications Commission (FCC)
- Accounting issues
- Issues concerning availability of information
- Issues concerning amount of financial commitment
- Doability issues
- Issues concerning ability to finance
- Issues concerning rate of return
- Social issues, including making deals with managements of the involved companies

Value Investors Know More Than Does the Outside Passive Minority Investor Market about Matters That Count

An important underlying assumption for value investing practitioners who are also well-financed buy-and-hold investors (i.e., not subject to margin calls and not involved in short-term risk arbitrage) is that given their investment objectives, they know much, much more than does the OPMI market about the particular investment. Indeed, active investors would never acquire a security unless they believed it to be materially mispriced by the OPMI market.

There are a number of corollaries that grow out of knowing more than the OPMI market. First, value investors never lose a night's sleep because of OPMI market prices. They know that it is an extremely rare event when an OPMI market action is more a determinant of how an in-

vestment might fare than is the bottom-up fundamental analysis of the investment situation. OPMI general market conditions were highly important in 1929, 1933, 1937, and maybe—but probably not—in 1974. In any event, market prognostications are of no importance in value investing. In the investor's lifetime, market conditions in politically stable environments in which there is no violence in the streets will be important so rarely that these macrofactors can be safely ignored.

By contrast, when you assume that the market knows more than the investor, it seems logical to worry about the market outlook, if for no other reason than that the market is sending the investor messages about value and trading.

Can anyone predict the course of OPMI markets? That is doubtful. What are market strategists good for? Comforting naive investors, not making accurate forecasts.

Earning Excess Returns Is the Norm in an Efficient Market

A market is defined as an arena in which participants reach agreements as to price and as to other terms that each participant believes are the best reasonably achievable under the circumstances. The attempt to obtain the best reasonably obtainable results is the hallmark of an efficient market. There are myriad markets, including OPMI trading markets, OPMI buy-and-hold markets, markets for control of companies, new-issue underwriting markets, markets for top management compensation, markets for the compensation of brokers and financial advisers, markets for the settlement of stockholder suits, and markets for consensual plans for companies reorganizing under Chapter 11 of the U.S. Bankruptcy Code.

Unless outside forces are going to impose disciplines that prevent excess returns from being earned, excess returns always will be earned by certain market participants as long as it is granted that markets tend toward efficiency. Indeed, excess returns have to follow as long as each participant seeks results he or she believes to be the best reasonably achievable under the circumstances. In other words, if circumstances are such that excess returns can be earned, excess returns will be earned.

Outside forces that impose disciplines in market circumstances include competitive pricing from other market participants, boards of directors,

government regulators, courts, labor unions, communities, creditors, trade vendors, landlords, taxing authorities, accountants, and attorneys. In certain markets, OPMI trading markets being a prime example, competitive forces impose a severe discipline. Here, excess returns are difficult to come by and earning them consistently may well be impossible. By contrast, in certain other markets, the market for top management compensation being a prime example, earning excess returns is the norm. Here, the external force primarily responsible for imposing discipline is the company's board of directors. Board control of top management compensation runs the gamut from very weak to nonexistent. This topic is more fully discussed in Chapter 8, Promoters and Professionals' Compensations.

Control Securities Are Essentially a Different Commodity Than Outside Passive Minority Investor Securities

The simple truth is that control common stocks tend to carry inherent rights, privileges, and obligations that do not exist for OPMI common stocks. Not only does pricing in control situations tend to be markedly different than pricing in OPMI situations, but pricing ought to be different simply because the control investor tends to focus on different variables than does the OPMI, and insofar as they both use the same variables, weights tend to be markedly different. Put otherwise, whereas control common stock is identical to OPMI common stock in form, control common stock tends to be a very different instrument than OPMI common stock in substance. This topic is discussed more fully in Chapter 6, The Substantive Characteristics of Securities.

Most of the Time, Capitalization Is Not Determined by Equity Investors' Needs or Desires

Academics, and to some extent Graham and Dodd, seem to believe that the appropriate capital structure of a company whose common stock is publicly traded is governed by considerations revolving around the maximization of shareholder value. Holding such a belief about most compa-

nies' capital structures seems akin to believing that the sun revolves around the earth. Rather, for most companies, capital structure is governed by the requirements imposed by creditors, regulators, rating agencies, and, in many instances, by conventional industry standards. This topic is discussed more fully in Chapter 7, Capital Structure.

Diversification Is Nonstarter in Most Markets

It is appropriate to diversify when you are investing under conditions where you lack control, knowledge of the fundamentals of the business in which a commitment is being made, and price consciousness. Diversification, in other words, is a surrogate—usually a poor one—for control, knowledge, and price sensitivity. Broad diversification is probably appropriate for OPMIs untrained in value investing precepts but most likely inappropriate for a control investor seeking to put together an LBO.

Every Investment Has Something Wrong With It

Graham and Dodd point out in credit analysis that bond selection is a negative art; the elimination from choice for investment of bonds that have something wrong with them. In value investing, equity selection is also a negative art. For each investment, virtually the first thing done in value investing is to figure out, as best as possible, what is wrong. Because every investment has something wrong, the trick is certainly not to find perfect investments but to arrive at judgments that not enough is wrong to dissuade investing.

Equity investing always involves trade-offs. Companies with very strong financial positions (i.e., the absence of debt and the presence of large amounts of liquid assets), tend to have, during prosperous times, considerably lower returns on assets and on equity than those of comparable companies that are more aggressive in financing their asset bases and employing those assets. On the other hand, those who finance aggressively and employ assets aggressively tend to lack a margin of safety, especially if, in bad times, they have difficulty gaining access to capital markets.

Simple businesses that do not require material investments in assets and that throw off huge amounts of cash (e.g., mutual fund management

companies and mobile home manufacturers) are inherently attractive, given the nature of their operations. As a trade-off, though, these are businesses marked by unusual ease of entry, so there tends to be increasing competition in these industries. An example of this is that the number of mutual funds that have come into existence since 1990. In mid-1997, around 7,000 mutual funds existed. In 1990, there were only 3100 mutual funds in existence.

Complex businesses that require massive capital investments (e.g., integrated steel companies or oil refiners), although relatively insulated from new competition, frequently fare rather poorly in down business cycles.

Finally, if a business as a business has "nothing" wrong with it, the price of its common stock might be too high. In value investing, a security's price is always an important variable. There is never any assumption that OPMI market price determines corporate value.

In value investing, there are no more important tasks than to try to figure out what is wrong and to reach judgments about whether what seems to be wrong ought to be a showstopper, precluding investment in the particular situation. Things that are wrong can include the following:

- A company with an extremely liquid financial position. Such a company may be run by an entrenched deadhead management that will never translate high-quality resources into wealth creation.
- A large ROE. Most of the time, this means a relatively small net asset value (NAV).
- A low ROE and a high NAV. This situation may mean that asset values are overstated.
- A large NAV. This can translate into a large earnings potential, large overheads, or both.