CHAPTER 1

"All Sensible Investing Is Value Investing"

A walk down any supermarket aisle makes it clear we live in a world of increasing product specialization. To break into a new market or grab more of an existing one, companies launch a dizzying array of new products in ever-more-specific categories. Want your soda with more caffeine or less? You've got it. More sugar? Less sugar? Six ounces, 10 ounces, 20 ounces? Whatever you like.

This trend has not been lost on marketers of investment vehicles. Specialized mutual funds and exchange-traded funds exist for almost every imaginable combination of manager style, geographic reach, industry sector, and company market capitalization size. If you're looking for a mid-cap growth fund focused on the commodity sector in so-called BRIC countries (Brazil, Russia, India and China), you're likely to find it.

We understand the marketing reality of specialization, but we argue that the most important factor in judging an investor's prospective gains or losses is his or her underlying philosophy. As you might guess from the fact that we co-founded a newsletter called *Value Investor Insight*, we agree 100 percent with Berkshire Hathaway's Vice Chairman Charlie Munger, who says simply that "all sensible investing is value investing."

But what exactly does it mean to be a value investor? At its most basic level it means seeking out stocks that you believe are worth considerably more than you have to pay for them. But all investors try to do that. Value investing to us is both a mindset as well as a rigorous discipline, the fundamental characteristics of which we've distilled down to a baker's dozen.

Value investors typically:

- Focus on intrinsic value—what a company is really worth—buying when convinced there is a substantial margin of safety between the company's share price and its intrinsic value and selling when the margin of safety is gone. This means not trying to guess where the herd will send the stock price next.

- Have a clearly defined sense of where they'll prospect for ideas, based on their competence and the perceived opportunity set rather than artificial style-box limitations.
- Pride themselves on conducting in-depth, proprietary, and fundamental research and analysis rather than relying on tips or paying attention to vacuous, minute-to-minute, cable-news-style analysis.
- Spend far more time analyzing and understanding micro factors, such as a company's competitive advantages and its growth prospects, instead of trying to make macro calls on things like interest rates, oil prices, and the economy.
- Understand and profit from the concept that business cycles and company performance often revert to the mean, rather than assuming that the immediate past best informs the indefinite future.
- Act only when able to draw conclusions at variance to conventional wisdom, resulting in buying stocks that are out-of-favor rather than popular.
- Conduct their analysis and invest with a multiyear time horizon rather than focusing on the month or quarter ahead.
- Consider truly great investment ideas to be rare, often resulting in portfolios with fewer, but larger, positions than is the norm.
- Understand that beating the market requires assembling a portfolio that looks quite different from the market, not one that hides behind the safety of closet indexing.
- Focus on avoiding permanent losses rather than minimizing the risk of stock-price volatility.
- Focus on absolute returns, not on relative performance versus a benchmark.
- Consider stock investing to be a marathon, with winners and losers among its practitioners best identified over periods of several years, not months.
- Admit their mistakes and actively seek to learn from them, rather than taking credit only for successes and attributing failures to bad luck.

WHAT IT MEANS TO BE A VALUE INVESTOR

Elaborating in detail on all aspects of the bare-bones list above is essentially what this book is about. We begin by turning to the uniquely successful investors we've profiled over the years as co-editors of *Value Investor Insight* to examine what they consider to be the key components of a value-investing philosophy, from general fundamental principles to the overarching mindset needed to make it work.

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Our entire process is rooted in Ben Graham's simple philosophical framework for investing. He believed there were two values for every stock, the first being the current market price, and the second what the share would be worth if the entire company were acquired by a knowledgeable buyer or if the assets were liquidated, the liabilities paid off and the proceeds paid to stockholders. He called that the intrinsic value and argued that the time to buy was when there was a large spread between the current price and that value, and the time to sell was when that spread was narrow.

Over time we've developed different ways of applying that —by valuing income streams rather than just assets, by calculating private market values, by investing internationally—but the essence of what we do has remained consistent. Our work every day is essentially directed at valuing what businesses are worth.

—Will Browne, Tweedy, Browne Co.

At the heart of being a value investor is having a contrarian bent. Beyond that, though, there are many different flavors of value investing. Tweedy Browne is a great deep-value investment firm. Chuck Royce at Royce Funds is a wonderful GARP [Growth At a Reasonable Price] practitioner—he's focused on value but definitely doesn't like to own bad companies. Mason Hawkins at Southeastern Asset Management and Marty Whitman of Third Avenue are oriented toward stocks trading at significant discounts to net asset value. Bill Miller is probably best described as an all-out contrarian. The fact that all these people have been successful proves that there's no single way to do it. What the market offers up as opportunity is constantly changing, so being able to deploy a variety of strategies as the situation warrants allows us great flexibility to go almost anywhere and never get shut out of the market. That's important because our investors don't ask us to move in and out of cash depending on how overvalued or undervalued we think the market is. And frankly, having an eclectic view makes investing a lot more interesting.

—Preston Athey, T. Rowe Price

We've found that to earn repeatable, excellent returns over time with reasonable risk exposure requires being able to assign something approximating a fair value to a business, making conservative estimates. Then it's a question of looking at the price. If price is significantly below that fair value, you're likely to have a good outcome by investing in it. If the price is significantly above that fair value, you can make good money by shorting it.

—Zeke Ashton, Centaur Capital

There's nothing particularly earth-shattering about what we try to do. We believe the market often misprices stocks due to neglect, emotion, misinterpretation or myopia, so our value-add comes from bottom-up stock selection. We're trying to buy at low prices relative to our current estimate of intrinsic value and we want to believe that intrinsic value will grow.

—Steve Morrow, NewSouth Capital

When I got much more interested in individual securities analysis in the early 1990s I read as widely as I could and a light bulb just switched on when I read everything Marty Whitman wrote. I was thinking it was critical to understand the ins and outs of how the stock market really worked, but his basic message was to ignore the market, which was just the bazaar through which you had to make trades. He was all about valuing what a company was worth—independent of what the market was saying it was worth at the time—and buying when the market was giving you a big discount and selling when it was paying you a premium.

As obvious as that sounds, it was very liberating to come across such a straightforward approach. Using whatever analytical tools I want, whether it's valuing net assets, calculating private-market values or discounting future cash flows, I can arrive at a clear estimate of what a company is actually worth. From there, the actual buying and selling decisions aren't that hard.

—Jim Roumell, Roumell Asset Management

I've heard it said many times that value investing is not as much about doing smart things as it is about *not* doing dumb things. Avoiding mistakes, resisting market fads, and focusing on allocating capital into ideas that are highly likely to produce satisfactory returns and that offer a margin of safety against permanent capital loss – these are the dominant themes of the value investing approach. Contrary to how it sounds, these elements don't make value investing easier than other approaches. In fact, cultivating the discipline to avoid unproductive decisions, refining the craft of valuing businesses and assessing risk, and developing the emotional and mental equilibrium required to think independently in a field in which there is tremendous pressure to conform requires constant diligence and effort.

—Zeke Ashton, Centaur Capital

Long-term-oriented value investors have greater scope to produce superior risk-adjusted returns when the seas are rocky. The valid response when there's chop is to focus on the end destination—what value investors call intrinsic value—and not worry about whether the next wave is going to push the boat up or down. If you don't invest with a very clear notion of underlying value, how do you do it? Nothing else makes sense.

Your ability to maintain focus on the long term comes from experience. You go through a couple cycles where everybody else is screaming at you not to try to catch a falling knife, and then when you do so and make some money, it does wonders for you . . . and for your ability to do it next time.

—Howard Marks, Oaktree Capital

We make no heroic assumptions in our analysis, hoping, instead, that by compounding multiple conservative assumptions, we will create such a substantial margin of safety that a lot can go wrong without impairing our capital much or even at all. We never invest just to invest and don't bet blindly on mean reversion or on historical relationships holding up. Our settings are permanently turned to "risk off."

—Seth Klarman, The Baupost Group

In traditional-value ideas we're looking for a large discount to our estimate of value based on a company's normal earnings power, where normal means that general business activity is not too hot and not too cold. These tend to be more average-quality businesses, which can get very cheap in the down part of a cycle or when dealing with a self-inflicted problem.

The priority in these ideas is on margin of safety, which we look at in two primary ways. The first is by making sure the potential downside is a small fraction of the upside. That means we avoid stocks that are cheap on an equity-value basis primarily because there's a mountain of debt. The second important way to have a margin of safety is to have more than one way to win, through earnings growth, multiple expansion or free options in the business.

—Lee Atzil, Pennant Capital

Whenever Ben Graham was asked what he thought would happen to the economy or to company X's or Y's profits, he always used to deadpan, "The future is uncertain." That's precisely why there's a need for a margin of safety in investing, which is more relevant today than ever.

—Jean-Marie Eveillard, First Eagle Funds

People should be highly skeptical of anyone's, including their own, ability to predict the future, and instead pursue strategies that can survive whatever may occur. [Nassim] Taleb advises us to be "anti-fragile" – i.e., to embrace those elements that benefit from volatility, variability, stress and disorder. This is exactly what we strive to do.

—Seth Klarman, The Baupost Group

The person with the highest probability of outperforming over time is the one who knows how to value companies and buys at a significant discount from that. I've heard for 45 years why all these other things have become more important. You know what? It's all crap.

—Robert Olstein, Olstein Capital Management

Much of what we do is focused on the concept of mean reversion. For a wide variety of inputs, such as P/E ratios, profit margins, sales growth and dividend yields, we assume everything will end up in seven years at normal. There's obviously judgment involved in defining what's normal, but we're pretty faithful historians who are also trying to use our brains and trying desperately not to lose money. For a long time we used 10-year forecasts, but have concluded through research that seven years is closer to the average time it takes for a financial series to mean revert.

—Jeremy Grantham, GMO

Price is perhaps the single most important criterion in sound investment decision-making. Every security or asset is a "buy" at one price, a "hold" at a higher price, and a "sell" at some still higher price. Yet most investors in all asset classes love simplicity, rosy outlooks, and the prospect of smooth sailing. They prefer what is performing well to what has recently lagged, often regardless of price. They prefer full buildings and trophy properties to fixer-uppers that need to be filled, even though empty or unloved buildings may be the far more compelling, and even safer, investments. Because investors are not usually penalized for adhering to conventional practices, doing so is the less professionally risky strategy, even though it virtually guarantees against superior performance.

—Seth Klarman, The Baupost Group

If I had to identify a single key to consistently successful investing, I'd say it's "cheapness." Buying at low prices relative to intrinsic value (rigorously and conservatively derived) holds the key to earning dependably high returns, limiting risk and minimizing losses. It's not the only thing that matters—obviously—but it's something for which there is no substitute. Without doing the above, "investing" moves closer to "speculating," a much less dependable activity.

—Howard Marks, Oaktree Capital

When you look back as far as 80 years for which we have data, rather than moving about without rhyme or reason, the stock market methodically rewards certain investment strategies while punishing others. There's no question the value-based strategies that work over long periods of time don't work all the time, but history shows that after what turn out to be relatively brief periods when other things seem to be all that matter, the market reasserts its preference for value, often with ferocity. My basic premise is that given all that, investors can do much better than the market if they consistently use time-tested strategies that are based on sensible, rational, value-based methods for selecting stocks.

—James O'Shaughnessy, O'Shaughnessy Asset Management

Warren Buffett has made the point many times that being contrarian really isn't the full answer—it's having conviction in your own opinion and filtering out the noise. If the market happens to be right, being a contrarian for the sake of being a contrarian isn't a very good strategy. You have to have the discipline to stick to the situations where you have an edge and sit out the rest of them.

—Jon Jacobson, Highfields Capital

There isn't really a strong value-investing culture in Europe—at least that operates the way we do. Most of the big institutions here define value in terms of high dividend yields and low P/E multiples on reported earnings. That's why so many of them did poorly in 2008, because they owned too many banks and cyclical companies. The majority of European hedge funds are traders who care little about valuation but are investing based on short-term news or momentum. Some are very good at it, but that's not at all what we do. We tell our investors that while they're betting on our skill in identifying corporate assets to invest in, in the end, they own high-quality assets. That's very different than investing in a trading hedge fund, where you're investing in the trading skill of the portfolio manager. If I have a bad day, that's not going to hurt the future prospects of the companies I own. If a trader has a bad day, it can be a disaster.

—Richard Vogel, Alatus Capital

In a rising market, everyone makes money and a value philosophy is unnecessary. But because there is no certain way to predict what the market will do, one must follow a value philosophy at all times. By controlling risk and limiting loss through extensive fundamental analysis, strict discipline, and endless patience, value investors can expect good results with limited downside. You may not get rich quick, but you will keep what you have, and if the future of value investing resembles its past, you are likely to get rich slowly. As investment strategies go, this is the most that any reasonable investor can hope for.

—Seth Klarman, The Baupost Group

Do those things as an analyst that you know you can do well, and only those things. If you can beat the market by charts, by astrology, or by some rare and valuable gift of your own, then that's the row you should hoe. If you're good at picking the stocks most likely to succeed in the next twelve months, base your work on the endeavor. If you can foretell the next important development in the economy, or in the technology, or in consumers' preferences, and gauge its consequences for various equity values, then concentrate on that particular activity. But in each case you must prove to yourself by honest, no-bluffing self-examination, and by continuous testing of performance, that you have what it takes to produce worthwhile results.

If you believe—as I have always believed—that the value approach is inherently sound, workable, and profitable, then devote yourself to that principle. Stick to it, and don't be led astray by Wall Street's fashions, its illusions, and its constant chase after the fast dollar. Let me emphasize that it does not take a genius or even a superior talent to be successful as a value analyst. What it needs is, first, reasonable good intelligence; second, sound principles of operation; third, and most important, firmness of character.

—Benjamin Graham, Common Sense Investing

Consultants in the investment world work so hard to pigeonhole investors that I think even the word "value" is misconstrued to just mean low multiples of book value or earnings. Even Ben Graham early on talked about how growth is of great value, it's just riskier and more difficult to quantify. I'm always amazed that someone would say they weren't a value investor—I wouldn't admit it even if I wasn't. It just seems silly to think about investing any other way.

—Thomas Gayner, Markel Corp.

DOES QUALITY MATTER?

No less an authority than Warren Buffett has described his evolution as a value investor from being more interested early on in "cigar-butt" types of companies—distinguished by little more than how inexpensive their stocks were relative to their tangible assets—to an emphasis on less-cheap, but higher-quality businesses with a sustainable ability to compound shareholder value over long periods of time. The relative importance one places on business quality remains a central element of just about any value-investing approach.

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I started out in 1974 with a Ben Graham value strategy, which suited my personality. For eight years the market did nothing, but it was a great time for stock pickers and value investing, so things went very well. Around 1982 it hit me that there were a lot of lousy stocks in my portfolio and I started wondering why. While it sounds like an obvious conclusion now, the common denominator of the losers was that they were in lousy businesses. I realized I should be more of a business analyst than a stock analyst, meaning that to create value as an investor I had to better understand how companies themselves created value. I moved more away from classical stock metrics of P/E and book value to business metrics of return on capital and cash flows.

—Andrew Pilara, RS Investments

Value to me often derives from competitively strong companies in structurally attractive industries supported by secular growth. In financial terms it's easy to describe a high-quality business. They generate high returns on unlevered capital and high returns on equity on an after-tax basis. They produce free cash flow or have attractive enough reinvestment opportunities to invest cash flow at high returns.

Great businesses are worth more, so I would rather own that type of company at a reasonable price than a mediocre company at a really cheap price. But I've also learned the hard way never to disregard valuation—you can easily overpay for even the best business.

—Morris Mark, Mark Asset Management

As a value investor, I was initially almost exclusively focused on companies with good balance sheets selling at low valuation multiples. There's nothing inherently wrong with that, but I've learned from experience that when cheapness blinds you to not-so-hot businesses or poor management, it's a recipe for disaster. We still only buy bargains, but we pay a lot more attention to things like whether the company's returns on capital are as good as they should be and at how adept and disciplined management is at allocating cash flow. When returns are inadequate or capital is allocated recklessly, equity value is usually destroyed.

—David Herro, Harris Associates

Our view is simply that superior long-term investment performance can be achieved when financially strong, competitively entrenched, well-managed companies are bought at prices significantly below their business value and sold when they approach that corporate worth. The quantitative piece of that is that we only want to buy when we can pay less than 60 percent of a conservative appraisal of a company's value, based on the present value of future free cash flows, current liquidation value and/or comparable sales.

—Mason Hawkins, Southeastern Asset Management

I began as a traditional value investor in the Ben Graham mold, looking for net-nets [companies trading for less than their current assets minus liabilities], discounts to book value and all of that. I would say, though, that I have graduated over time to be more focused on very good companies selling at fair prices.

—Prem Watsa, Fairfax Financial

I have come to the conclusion, as others have, that in general you find better investments in businesses with good economics, secular tailwinds, and sustainable competitive advantages than you do in trying to get one last puff out of proverbial cigar butts. When everything's out of favor and you can buy businesses with bright futures without having to pay for that future, that's a wonderful thing.

—David Winters, Wintergreen Fund

I've learned that to meet my return goals I can't have big losers. So regardless of how cheap something is or how much potential upside there is, that means avoiding companies that can wipe out—with too much debt, unproven business models, secularly challenged end markets or no durable competitive advantages.

—Zeke Ashton, Centaur Capital

What I'm looking for are steady cash flows, reinvested on owners' behalf by honest and able management. Steady cash flows come from businesses that, for one reason or another, enjoy the perception of indispensability for their products. This perception of indispensability often comes from a brand, but can also be from real barriers to competition. If you have the only quarry in town, it's hard for competitors to ship into your market because transportation costs are so high.

—Thomas Russo, Gardner Russo & Gardner

For the past 30 years we've sort of floated in style between Ben Graham and Warren Buffett. Graham's approach is static, quantitative, and focused on the balance sheet. There's no attempt to look into the future and judge the more qualitative aspects of the business.

Buffett's major idea was to also look more qualitatively for those few businesses with apparently sustainable competitive advantages, where the odds were fairly high that the business would be as successful ten years from now as it is today. In those situations, one makes money not so much from the elimination of the discount to intrinsic value, but more from the growth in that intrinsic value.

When I started out in 1979, both in the U.S. and Europe, there were many Ben Graham-type stocks to uncover after the dismal stock performance of the 1970s. As we grew and markets changed, we've moved more to the Buffett approach, but not without trepidation. If one is wrong in judging a company to have a sustainable competitive advantage, the investment results can be disastrous. With the Graham approach, the very large discount to static value minimizes that risk. Overall, I'd like to believe we've learned well from both Graham and Buffett and that we own securities that would attract each of them.

—Jean-Marie Eveillard, First Eagle Funds

We have moved more from a pure Benjamin Graham style of value investing to one closer to Phil Fisher and Warren Buffett, in the sense that we're putting even more weight on the quality of the business. I don't know, maybe when you're younger you just care about getting things that are cheap and making money fast. But as you become old you see that buying companies with high and sustainable returns on capital at reasonable prices tends to work a little bit better.

—Francisco Garcia Parames, Bestinver Asset Management

What we've tried to do is marry the Graham-and-Dodd type emphasis on margin of safety with the more modern version of value investing that focuses on a company's sustainable ability to generate returns on invested capital (ROIC) that exceed its cost of capital. For ROIC we use earnings before interest and taxes, divided by the sum of net working capital and property, plant and equipment, less cash. That measure consistently exceeding the cost of capital means the net asset value is likely to grow and the business can be worth considerably more than the net value of those assets.

—Ari Levy, Lakeview Investment Group

Speaking broadly, probably 10 percent of the businesses out there are lousy, such as selling pure commodities where the marginal cost of production drives the pricing and companies find it very hard to earn even the cost of capital over time. I may own such a company from time to time, but it's rare.

At the other end of the spectrum are another maybe 10 percent of businesses which are of excellent quality. A perfect example would be money management firms, which in aggregate earn obscene returns on equity. We love to own these types of companies, but the opportunities to buy them cheaply are relatively few and far between.

So that leaves us most occupied with the other 80 percent, in which there's a changing roster of winners and losers. Those changes in fortunes are typically tied to cycles and how individual companies are managed, which are the types of things we believe we can analyze and judge. In a lot of our companies, just getting back to average operating performance can result in excellent investment results.

—Preston Athey, T. Rowe Price

We would love to own great businesses as much as the next guy, but the problem is finding them at the right price. We're perfectly happy looking for the average company, where we think there's something going on which the market hasn't recognized that can make it better than average. You're rewarded as much for that as for a good company becoming very good.

We do make every effort to understand what edge the company has in facing competitive threats or maintaining pricing power. When that edge isn't clear, you have to be very careful about the valuation you assign to the earnings and cash flow stream. But business quality, in and of itself, isn't paramount to our decision to buy.

—Vincent Sellecchia, Delafield Fund

We aren't obsessed with perfection and quality. I've made some very nice investments in companies that were going from terrible to bad or bad to fair. We're just looking for the biggest mismatch between value and price—where those occur on the quality scale can change over time.

—Carlo Cannell, Cannell Capital

Everything doesn't have to be the next Microsoft—we may invest in a company because the market thinks it's going to fail, and we don't.

—Lee Ainslie, Maverick Capital

When I talk about the companies I invest in, you'll be able to rattle off hundreds of bad things about them—but that's why they're cheap! The most common comment I get is "Don't you read the paper?" Because if you read the paper, there's no way you'd buy these stocks.

They're priced where they are for good reason, but I invest when I believe the conditions that are causing them to be priced that way are probably not permanent. By nature, you can't be short-term oriented with this investment philosophy. If you're going to worry about short-term volatility, you're just not going to be able to buy the cheapest stocks. With the cheapest stocks, the outlooks are uncertain.

In my whole career I have yet to find the great business with a wonderful management team, high margins, a dominant market position and all the conditions everybody wants, at a low price. The stocks of such companies don't sell at a low price. If I find one, I'll cheer, but it hasn't happened yet.

—Richard Pzena, Pzena Investment Management

People often say they emphasize the quality of management or the competitive moat of a company, but the problem with some of those generalizations is that companies with those attributes are very often not attractively priced. Procter & Gamble may today be considered one of best-managed companies in the world, with some of the best brand franchises and with very low-risk equity, but if the stock is not attractive at the current price, none of the rest matters.

—Ric Dillon, Diamond Hill Investments

I'm generally not obsessed with quality. Good assets bought at the wrong price can be terrible investments, just as lousy ones bought very cheaply can generate excellent results.

That anything is attractive at a price might seem intuitively obvious, but many investors consistently ignore it. People feel better in our business when prices are going up, so you consistently see buyers come in after markets have been good, while people tend to move to the sidelines and watch when markets are bad. People are, in general, momentum investors, which is completely at odds with being a value investor and which can create opportunities for those who are disciplined and patient.

—Jon Jacobson, Highfields Capital

THE VALUE OF GROWTH

A corollary issue to business quality is the emphasis value investors place on a company's ability to grow. Distinctions tend to be made in how heavily weighted growth is in the assessment of value and in the conservatism with which future estimates are made, but avowed value investors typically resist being labeled as unconcerned with growth in assessing a company's intrinsic value.

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Positioning value versus growth sets up a false comparison. They are not opposite ends of the spectrum—value investing and momentum investing are at opposite ends. All else equal, after a stock price falls with no change in its estimated value, a value investor will find it more attractive. A momentum investor reacts in the opposite way; a price decline makes the stock less attractive, and vice versa.

A value investor needs to be able to assess the value of many business characteristics, such as balance sheet strength, cash-generating ability, franchise durability, and so on. Growth is also one of those factors. The ability to grow organically is almost always a positive. It would be a negative only if that growth required so much investment that it had a negative present value. That almost never happens. Ten to 15 years ago, investors were paying a very high price for growth. Many stocks traded at barely double-digit P/Es, but large-cap companies that had above-average expected growth were trading at 50 times earnings and higher. At that spread, we believed growth was way too expensive, and it was an easy choice to avoid it. More recently, valuations have compressed, meaning the price of growth has sharply fallen. When we can get more growth without having to pay for it, the choice again becomes very easy.

I see value investing as applying a consistent discipline to a changing marketplace. As the price investors pay for growth becomes excessive, applying our price discipline moves us away from growth. As the price for growth declines, our discipline moves us toward higher-growth businesses.

—Bill Nygren, Harris Associates

I don't get overly concerned with how my portfolios are categorized. Our mutual fund was originally called a value fund, then it was a "core" fund, and now it shows up sometimes as a growth fund. Through all that, we haven't changed anything we do since day one—the notion that growth is a creator of value is an important part of how we invest.

—Chuck Akre, Akre Capital Management

People often make it sound complicated, but investing is really all about estimating what something is worth and then buying it at an attractive price. Even though we have a classical value approach—analyzing stocks as an ownership stake in a business, calculating intrinsic values, requiring a margin of safety—we don't call ourselves value investors in any of our marketing or other communications. Borrowing from Warren Buffett, as we so often do, we see growth and value as all part of the same equation—to separate them strikes us as kind of dumb. There should be fairly broad agreement that what constitutes value are a company's discounted future cash flows—the growth in those cash flows is obviously central to figuring that out.

—Ric Dillon, Diamond Hill Investments

We believe the most important contributor to the long-term investment performance of the companies we own is earnings growth, not a change in valuation. Because growth is driven by earning high returns on capital and successfully reinvesting cash flow, we tend to be very long-term investors—our average holding period runs about seven years—in order for this virtuous process to bear fruit. Because of that orientation, we put primary emphasis on market structure, the sustainability of the business's competitive advantage, and management's track record in creating shareholder value over time.

If you step back and think about the basics of what we're doing, we're interested in companies that are better than their competitors and which have shown the ability to take the cash they earn and do something smart with it. There's nothing earth-shattering about that, but to the extent you can apply it, understand the business dynamics and not pay foolish prices for things, there's no reason you shouldn't get the attractive long-term returns we believe we and our predecessors have produced.

—Eric Ende, First Pacific Advisors

When I started in the business and for a long time, my concept of value was absolute value in terms of a price-earnings ratio. But I would say my concept of value has changed to a more relative sense of valuation, based on the expected growth rate applied against the price of the stock. Something trading at 30× earnings that is growing at 25 percent per year—where I have confidence it will grow at that rate for some time—can be much cheaper than something at 7× earnings growing at 3 percent. Some people call that GARP (Growth-at-a-Reasonable-Price) investing, I'd call it value. I think that's just semantics.

We've always had excellent analysts, and a good analyst is more adept at making judgments on growth. That's their job—based on the business and the company's position in it, how fast is the company going to grow? It's pretty hard to lose if you're right on the growth rates when the growth rates are high. In that 30× P/E company growing 25 percent per year, you'll be bailed out pretty quickly because in about $2^1/_2$ years the earnings will double and the multiple on that will go to only 15×.

—Julian Robertson, Tiger Management

I'm a value investor, which says I want to buy 50-cent dollars, but given my firm's predilection for serving the needs of taxable investors, I also want that dollar to tax-efficiently compound in value over long periods of time. That means the businesses I find attractive must have great capacity to reinvest, which is not all that common.

—Thomas Russo, Gardner Russo & Gardner

In such a value-focused world, we need to be all the more contrarian in our views. It also requires additional research focus on unique, future-potential situations that might traditionally have been called growth ideas. This is just a practical response. As defined in classical Graham and Dodd terms, a bargain-basement stock has a market capitalization lower than its net working capital—current assets minus current liabilities. The approximate number of companies selling at a discount to net working capital today is zero.

—Murray Stahl, Horizon Asset Management

In my experience, it's been more important to be involved with a powerful trend with accelerating potential returns than to get too hung up on valuation. That's not at all to say valuation doesn't matter, but there have been many times when I've been right about the trend but didn't buy a leader because it was 20 percent too expensive and that turned out to be a mistake.

—John Burbank, Passport Capital

To me, investing success is 50 percent analytical ability and 50 percent understanding and playing off the market's psychology. We are serious students of macroeconomic influences and trends, and are most interested when industry sectors that should benefit from major demographic, technological, or economic shifts are out of favor.

—Ralph Shive, Wasatch Advisors

If you're looking, as we are, for extraordinary returns—from companies whose stocks can go up 10× rather than 2×—it's far more likely to happen because the company's earnings turn out to be so much better than anyone expected than because you found a temporary 50-cent dollar.

—John Burbank, Passport Capital

I'm looking for opportunities in which I have a differentiated view on forward earnings, preferably revenue-driven. You generally make money in three ways on the long side: your estimates are higher than the Street's and the consensus moves to your numbers, the earnings grow, or the earnings multiple expands. By and large, the multiple is likely to expand the most in situations where revenue is accelerating.

—Jed Nussdorf, Soapstone Capital

I tend to look at multiples in absolute terms and am quite comfortable with 12 to 13× multiples of net income when I believe there's an opportunity for faster growth in earnings—for clearly defined reasons—than the market expects.

I do think it's dangerous to lock yourself into rules. So many people miss out on great opportunities because a stock only gets within a quarter point of their price target. I try to avoid being overly rigid.

—Thomas Russo, Gardner Russo & Gardner

While price obviously matters, if we're right on the big picture, I don't need a screaming bargain to do well—compounding value can cover up a lot of sins.

—Thomas Gayner, Markel Corp.

We have learned from experience that the credible expectation of intrinsic-value growth is a helpful guard against value traps. We'd rather own a full-priced business with potential 15 percent per year intrinsic value growth than something at a 30 percent discount that has no growth. The math works in your favor. Ideally, of course, we're shooting for both the growth and the discount.

—Steve Morrow, NewSouth Capital

I've read that the average holding period on the New York Stock Exchange is nine months, which I don't even consider investing. Over such a short period of time you're just betting on the overall direction of the market or on the next quarterly earnings. I typically don't even make quarterly projections, but get excited when I see excellent growth potential over time for which I'm paying next to nothing because the market is ignoring it.

—Aaron Edelheit, Sabre Value Management

Many value investors are primarily focused on price and valuation, which we obviously think are important, but we also believe that when constructing a portfolio you should have companies with promise beyond just going from undervalued to fairly valued.

Basic-value stocks make up about 40 percent of the portfolio [and] consistent earners, blue-chip companies that tend to have long records of steady organic revenue and profit growth but every once in a while become out of favor, also make up around 40 percent of the portfolio. The last category we try to own are emerging franchises, which are typically younger companies with excellent growth prospects. Because they often have a narrow product lineup, they fall out of favor when one or a few important products suffer from inevitable hiccups in growth. I often say the only small company we want to buy is one that can become a big company—that's what we're looking for in emerging franchises.

—William Fries, Thornburg Investment Management

We tend to like equity ideas that have almost bond-like qualities, where cash is being generated in a fairly predictable way and being used to pay down debt or return capital to shareholders through dividends or stock buybacks. Companies in growth mode, reinvesting all of their cash, are more like zero-coupon bonds and are more difficult for us to get our hands around. It's not that we never invest in growth ideas, but it's not our focus.

—Mitchell Julis, Canyon Capital

We expect to generate the vast majority of our returns not from the growth in the value of the business, but from the unwinding of the value discount. We're more than happy to see growth potential and we recognize how valuable it can be, but higher-growth businesses typically expose us to more valuation risk than we're comfortable with.

—David Samra, Artisan Partners

THE VALUE MINDSET

While the success of any investment strategy bears heavily on the intelligence and technical skill of its practitioners, value investors also believe their competitive advantage rests upon the unique and multifaceted value mindset they possess. It's an attitude as much as a strategy, born more than bred, and indispensible to their ability to outperform over time.

* * *

Starting with the first recorded and reliable history that we can find—a history of the Peloponnesian war by a Greek author named Thucydides—and following through a broad array of key historical global crises, you see recurring aspects of human nature that have gotten people into trouble: hubris, dogma, and haste. The keys to our investing approach are the symmetrical opposite of that: humility, flexibility, and patience.

On the humility side, one of the things that Jean-Marie Eveillard firmly ingrained in the culture here is that the future is uncertain. That results in investing with not only a price margin of safety, but in companies with conservative balance sheets and prudent and proven management teams. If you acknowledge your crystal ball is at best foggy, you follow the advice of Ben Graham and invest to avoid the landmines.

In terms of flexibility, we've been willing to be out of the biggest sectors of the market, whether it was Japan in the late 1980s, technology in the late 1990s or financials the late 2000s. That wasn't necessarily because of any particular gift of foresight, but reflected a recognition that each of those areas embodied very widely accepted and high expectations. It's painful and not socially acceptable to be out of the most revered sectors of the market, but those types of acts of omission have been a key contributor to the strong performance.

The third thing in terms of temperament we think we value more than most other investors is patience. We have a five-year average holding period. Particularly in a volatile market like today's, people are trying to zig and zag ahead of every market turn that they're hoping they can forecast with scientific precision. We like to plant seeds and then watch the trees grow, and our portfolio is often kind of a portrait of inactivity. That's kept us from making sharp and sometimes emotional moves that we eventually come to regret.

—Matthew McLennan, First Eagle Funds

The key to the success of value investing is that it is basically contrarian investing. How can you buy something at a value price if it's desired by the world? Investors go out of their way to look for companies with certain cash flow characteristics, returns on assets that are stable and that have objectively verifiable tangible assets that could be liquidated at some point. If that's going to be the focus for literally thousands of funds . . . how could you possibly have outstanding results by just doing the same thing?

—Murray Stahl, Horizon Asset Management

It's important to play to your strengths. As an investor, I'm not a home-run hitter and can't think of a lot of securities on which I've made 10 times my money. But I also can't think of a lot of securities, post-1970, on which I've lost a meaningful amount of capital. Success in investing is not really much more complicated than that.

—Spencer Davidson, General American Investors

It's hard for most people to grasp that a great company is not always a great stock, and that a great stock is not always a great company. Value works because you're consistently paying less to get more. Over time that works a lot better than paying more to get less.

—James O'Shaughnessy, O'Shaughnessy Asset Management

Going against the grain is clearly not for everyone—and it doesn't tend to help you in your social life—but to make the really large money in investing, you have to have the guts to make the bets that everyone else is afraid to make.

—Carlo Cannell, Cannell Capital

Our worst mistakes have been far more likely a result of our being a follower rather than a leader. We've been much less successful buying into stories that are out there already than ones that we're anticipating in advance.

—Sam Isaly, OrbiMed Advisors

It's important to remember as a contrarian investor that the consensus is often right. My colleague François Sicart likes to say, "Just because everyone says it's raining outside is no reason not to take an umbrella." But because we believe the consensus is priced into any given investment, going along with that is a very hard place from which to make money.

—Robert Kleinschmidt, Tocqueville Asset Management

Value investors tend to have a different default question in looking at a potential opportunity. Most investment managers ask "Can I own this?"—to which the answer is generally yes. Value investors put a different burden of proof on every idea by asking, "Why should I own this?" That degree of skepticism is a valuable trait.

—James Montier, Société Générale

We do tend to be a little dour at times and we definitely take a skeptical view of the facts. Warren Buffett once said, "You pay a very high price for a cheery consensus." Value investors simply don't believe in cheery consensus. That's not a criticism—I'd consider it a badge of honor.

—Daniel Bubis, Tetrem Capital

Most investors take comfort from calm, steadily rising markets; roiling markets can drive investor panic. But these conventional reactions are inverted. When all feels calm and prices surge, the markets may feel safe; but, in fact, they are dangerous because few investors are focusing on risk. When one feels in the pit of one's stomach the fear that accompanies plunging market prices, risk-taking becomes considerably less risky, because risk is often priced into an asset's lower market valuation. Investment success requires standing apart from the frenzy—the short-term, relative performance game played by most investors.

—Seth Klarman, The Baupost Group

What you should do is take a dim view of what's been appreciating and be interested in what hasn't been good to you. You certainly want to understand why any asset class has been going down, but you should celebrate the fact that it has been getting cheaper. To say price going down is a good reason to look the other way is like saying you'd never go shopping when stores are running sales.

—Howard Marks, Oaktree Capital

We're classic value investors in the sense that when share prices are low, we think risk is low as well. Most people can understand that in theory but don't believe it in practice and even act as if it's heresy. It's actually when prices are rising and stocks are converging with our share-price targets that we find risk far more uncomfortable.

—Sarah Ketterer, Causeway Capital

Someone asked me the other day whether watching what was going on [in troubled markets] felt lousy, and of course it does. But you can only buy quality cheap when people are afraid. We earn our keep much more in difficult markets than when everybody's serene and happy.

—David Herro, Harris Associates

I'm perfectly fine if Mr. Market wants to go down another 15 to 20 percent—we'll just buy more stocks. It's not during up years that great investment track records are made!

—Charles de Vaulx, International Value Advisers

The market is extremely noisy, but you just can't let that distract you from your discipline and your framework. We've said this since we started out: The market is really just a pendulum that forever swings between unsustainable optimism, which makes stocks too expensive, and unjustified pessimism, which makes them too cheap. All we're trying to do is keep a level head, sell to the optimists, and buy from the pessimists.

—Jonathan Shapiro, Kovitz Investment Group

Warren Buffett is right when he says you should invest as if the market is going to be closed for the next five years. The fundamental principles of value investing, if they make sense to you, can allow you to survive and prosper when everyone else is rudderless. We have a proven map with which to navigate. It sounds kind of crazy, but in times of turmoil in the market, I've felt a sort of serenity in knowing that if I've checked and rechecked my work, one plus one still equals two regardless of where a stock trades right after I buy it.

—Seth Klarman, The Baupost Group

When you have a model you believe in, that you've used for a long time and which is more empirical than intuitive, sticking with it takes the emotion away when markets are good or bad. That's been a central element of our success. It's the emotional dimension that drives people to make lousy, irrational decisions.

—Will Browne, Tweedy, Browne Co.

I like to say that changing investment styles to the latest fad produces the same results as changing lanes during rush-hour traffic jams: You increase the risk of an accident with little chance of achieving better results. The psychological pain of sticking to your guns, though, is tough. I was up 35 percent in 1999 but had people telling me I didn't have enough technology in my fund and they were taking money out. This is not nuclear physics, but [it's] hard to stick to your guns when the crowd's running over you. We don't believe value investing is ever out of style—it just doesn't work all of the time.

—Robert Olstein, Olstein Capital Management

The real secret to investing is that there is no secret to investing. Every important aspect of value investing has been made available to the public many times over, beginning with the first edition of *Security Analysis*. That so many people fail to follow this timeless and almost foolproof approach enables those who adopt it to remain successful. The foibles of human nature that result in the mass pursuit of instant wealth and effortless gain seem certain to be with us forever. So long as people succumb to this aspect of their natures, value investing will remain, as it has been for 75 years, a sound and low-risk approach to successful long-term investing.

—Seth Klarman, The Baupost Group

It is occasionally possible for a tortoise, content to assimilate proven insights of his best predecessors, to outrun hares which seek originality or don't wish to be left out of some crowd folly which ignores the best work of the past. This happens as the tortoise stumbles on some particularly effective way to apply the best previous work, or simply avoids standard calamities. We try more to profit by always remembering the obvious than from grasping the esoteric. It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.

—Charlie Munger, Poor Charlie's Almanack

In a world in which most investors appear interested in figuring out how to make money every second and chase the idea *du jour*, there's also something validating about the message that it's okay to do nothing and wait for opportunities to present themselves or to pay off. That's lonely and contrary a lot of the time, but reminding yourself that that's what it takes is quite helpful.

—Seth Klarman, The Baupost Group

One investor who has greatly influenced me from a conceptual standpoint is Howard Marks, the Chairman of Oaktree Capital. He's not an equity investor, but he describes this notion of running a core strategy, focused on beating the market through the accumulation of small but high-probability advantages over a long period of time. The alternative, which can also be a legitimate strategy, is to swing for the fences with the goal of hitting enough home runs to drive outstanding performance. The high-probability approach is consistent with my personality.

—Zeke Ashton, Centaur Capital

I feel strongly that attempting to achieve a superior long-term record by stringing together a run of top-decile years is unlikely to succeed. Rather, striving to do a little better than average every year, and through discipline to have highly superior relative results in bad times, is: (1) less likely to produce extreme volatility; (2) less likely to produce huge losses which can't be recouped, and (3) most importantly, more likely to work.

—Howard Marks, Oaktree Capital

One of the temptations of a professional investor is that one is often drawn towards difficult analytical problems in search of a big payoff. If anything, this temptation has been amplified in recent years by the acclaim and financial rewards that have accrued to those who end up on the right side of a big, dramatic bet – the more complex, the better. The problem is that such success is hard to maintain, hard to predict, and generally creates further pressure to find similarly difficult, large-scale mispricing opportunities to exploit in the future. Such opportunities may not be available most of the time, which may explain why many of those investors who get things dramatically right one year find themselves getting it dramatically wrong the next. At the end of the day, being consistently smarter than the rest of the market is probably next to impossible to do.

—Zeke Ashton, Centaur Capital

I don't think being a value investor is something you can learn. You can learn how to be better at it and the analytical support for it, but you can't sit there and say, "I'm going to make an intellectual decision that I'm going to become a value investor." My personal belief is that you're either born as a bargain-hunter type or you're born as a bright-eyed optimist. You have to be skeptical and pessimistic, and you have to really enjoy the bargain-hunting process, and it has to be part of your whole life. I find that the people who are the best at this are the type of people who are absolutely thrilled to find a pair of shoes for $20 that they could have paid $150 for at a department store.

—Richard Pzena, Pzena Investment Management

Some of the best early advice I got was to forget all I'd learned in business school about efficient markets and instead read Ben Graham. You either take to it or you don't, and I knew right away that this was how I wanted to do it.

—Prem Watsa, Fairfax Financial

We consistently articulate two goals—to achieve positive returns and to outperform the market. If you aren't going to make money owning our mutual fund, then there's no point in buying it. And if you aren't going to make more money than you would have in an index fund, we're not worth our fees.

At the end of 2010 I looked at the previous decade for the Oakmark Fund, to see in how many quarters we could tell our investors that we both made money and that we made meaningfully more—which I defined as 100 basis points—than the S&P 500. Of the 40 quarters, only eight qualified as winners. That's like hitting .200 in baseball, just one out away from a ticket to the minor leagues.

For those 10 years, however, the fund returned 74 percent, versus 15 percent in total return for the S&P 500. So even though we were most often frustrated because we lost money or didn't make as much as somebody else, over that period we beat 96 percent of competing funds and did more than 400 basis points better per year than the market. That to me is kind of the essence of value investing. We often don't keep up with strong markets, but make up for it by losing less during market declines. Expectations for companies we own are typically quite low, which means they don't usually fall as much as the market does when times get tough.

It is a limited set of people who have the personality and discipline to successfully invest this way. I guess that's why we can continue to put food on the table.

—Bill Nygren, Harris Associates

Value investing strategies have worked for years and everyone's known about them. They continue to work because it's hard for people to do, for two main reasons. First, the companies that show up on the screens can be scary and not doing so well, so people find them difficult to buy. Second, there can be one-, two- or three-year periods when a strategy like this doesn't work. Most people aren't capable of sticking it out through that.

—Joel Greenblatt, Gotham Capital

If you are a value investor, you're a long-term investor. If you are a long-term investor, you're not trying to keep up with a benchmark on a short-term basis. To do that, you accept in advance that every now and then you will lag behind, which is another way of saying you will suffer. That's very hard to accept in advance because, the truth is, human nature shrinks from pain. That's why not so many people invest this way. But if you believe as strongly as I do that value investing not only makes sense, but that it works, there's really no credible alternative.

—Jean-Marie Eveillard, First Eagle Funds
