Chapter 1

The 5 Misconceptions of Value Investing

We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.[1]

—Warren Buffett

COPYRIGHTED MATERIAL

Whenever I go to a dinner party or social gathering, a friend or acquaintance usually asks my opinion on the economic news flash of the day. For example, if the media are talking about the DJIA making an all-time high or an unemployment report coming in better than expected, people who know that I manage a limited partnership and write an investment newsletter want to hear my take on current economic events. I usually respond the same way each time I am asked: "I really don't have a clue how it will affect the stock market or the economy." I'm not trying to brush them off, but I really don't know. In fact, I don't even take those factors into account when making a purchase.

DJIA
An index of 30 stocks traded on the public exchanges. It is the most widely known index and is used as a measure of the health and direction of the overall stock market.

Top-Down Approach vs. Bottom-Up Approach

Because I follow a *value investing* philosophy, I have the advantage of taking a *bottom-up approach*, which means identifying investment opportunities one at a time through analysis of financial statements. In contrast, most professional investors take a *top-down approach*, which carries with it greater risk of being wrong. Let's look at the way the top-down and bottom-up approaches differ, and you decide which approach carries with it a higher degree of uncertainty.

value investing
a method of determining the value of a business and then buying shares at a discount from that value.

top-down approach
a method of identifying investment opportunities by making a prediction about the future, determining the investment consequence, and then selecting the proper security.

Top-Down Approach

The largest 100 *money managers* hold $6.8 trillion of stocks or 52 percent of the U.S. stock market's total market capitalization. Eighteen managers each supervise more than $100 billion of U.S. equities, including four managers who each hold some $400 billion or more.[2]

A large percentage of these money managers employ a top-down approach when making an investment in stocks. This involves three steps:

1. Making a prediction about the future.
2. Discerning its effect on the investment.
3. Making the trade.

bottom-up approach
a method of identifying investment opportunities one at a time through analysis of financial statements and the outlook of the company.

This approach is a very risky way to go because each step of the way is subject to error. Money managers who take this path are basically making a big picture or macro bet on the future. Once they pass that hurdle, they are faced with interpreting the impact of their decision on the sector, industry, and then company in order to maximize the value of their prediction. If that weren't hard enough, they then

TABLE 1.1 Top-Down Approach Exercise

1. Big-picture prediction	A weak U.S. economy
2. Conclusion drawn from prediction	Value of U.S. dollar should decline
3. Areas of investment	U.S. companies—large exposure to foreign currency
4. Specific investments	Coca-Cola, IBM, Pfizer, and so on.
5. Timing	Need to purchase ahead of crowd

have to act quickly before the rest of Wall Street makes the same trade, causing prices to rise and minimizing any profit potential they would have had.

money managers in return for a fee, persons responsible for buying and selling a portfolio of securities.

Now consider an example of all the steps that a top-down investor has to get right to make a profitable decision. Table 1.1 shows how a weak U.S. economy has to be called right.

The top-down investor is faced with many unknowns, and also has to play beat the clock. For example, even if the top-down investor is correct on the big-picture prediction, the conclusion from that prediction and the area of investment (i.e., a weak U.S. economy will cause the dollar to decline, making companies that have large foreign-currency exposure show higher earnings because of currency gains), they can still drop the ball and pick the wrong specific investment (bought Coca-Cola instead of IBM) and even lose money on the trade. Then they have to make the correct specific investment (i.e., Coca-Cola, IBM, Pfizer, etc.) ahead of the other thousands of money managers who are all looking at the same big-picture prediction.

When they are buying the specific investment, what kind of margin of safety will they have? They are buying based not on value but on which company, regardless of stock price, will move higher the fastest. And one last hurdle: Top-down investors have to know when the trend has run its course. How much of the recent stock move is already factored into the price? For me, the top down approach is fraught with risks each step of the game and does not offer any margin of safety that would satisfy me.

Bottom-Up Approach

The bottom-up approach used by investors employing a value investing philosophy is much easier to execute and doesn't require making predictions of events

that are unknowable. Bottom-up investors look at stocks one at a time and use good, old-fashioned analysis such as reading the company's *annual report* and *SEC Form 10-K*s. After evaluating the company and determining an appropriate price to pay (which includes a margin of safety), they then check the price the stock is trading.

annual report
a booklet prepared by management that describes the financial condition and company operations, which is distributed to all shareholders on a yearly basis.

SEC Form 10-K
audited report filed annually with the Securities and Exchange Commission. Similar to the shareholder annual report but provides more detailed financial and nonfinancial information.

If the stock is currently trading below the price they used to determine the underlying worth of the business, they will buy the stock and wait patiently for it to rise. That's it. In the short term, it really doesn't matter much what the economy, the stock market, or the U.S. dollar will do, as long as the bottom-up investor was able to buy $1 worth of value for 70¢. In other words, this whole approach can be described as "buy it cheap and forget it."

The hard part for bottom-up investors is the lack of activity; but keep in mind, the market rewards patience. It could take months or even years for the stock market to reward you for your patience. But if you have the correct temperament and are not swayed by the daily gyrations of the stock market, you will be rewarded when the underlying value of the business catches up with the price you paid for the stock.

If you act as a bottom-up investor, the unknown factors are mostly within your control. You only have to be right regarding the valuation of the company at the time you bought the stock. If you take the time to figure out the underlying worth of the business and make sure there is a wide gap between valuation and price (the wider the gap, the greater the margin of safety), you will be able to figure out the potential risk and reward on your investment.

For example, if your analysis concludes that Coca-Cola is worth $50 a share, and the stock is currently trading at $35 per share, or 30 percent lower than the current price, you already know you have the potential to make a 43 percent on your investment. Even if you are wrong on the valuation and it really should have been valued at $45 a share, (or $10 higher than your initial valuation), you can still walk away with a 29 percent return. (Value is $45; you buy it at $35: The difference of $10 is a 29 percent profit.)

The Easier Game

The examples just mentioned make the point and tell you which approach allows you to sleep better at night. When you follow a bottom-up approach, the chance for errors and mistakes along the way will be much lower than the chance of trying to predict the future of the U.S. economy or what inflation will be over the next five years. Legendary fund manager Peter Lynch offered very sound advice about making predictions:

> Nobody can predict interest rates, the future direction of the economy, or the stock market. Dismiss all such forecasts and concentrate on what's actually happening to the companies in which you've invested.[3]

It's much easier to stick to what you can know rather than trying to figure out the unknowable.

The biggest problem I see for top-down investors is in determining when the investment no longer makes sense or simply knowing when they are wrong. They also have to speculate on the magnitude of their prediction. If they predict that the U.S. dollar will fall, they then have to predict by how much so they can capitalize on their prediction.

That is something the bottom-up investor doesn't have to waste time worrying about. If the company undergoes new management, or a supplier or sales channel suddenly closes up, the bottom-up investor would then be able to assess and reevaluate the situation. For top-down investors, there is no clear answer; the best they can do is to make a judgment call. Judgment calls made in the heat of the moment are usually wrong. In addition to the logic and simple steps used by a bottom-up investor, I promise you will sleep better at night. And to me, that is worth all the tea in China.

Common Misconceptions about Value Investing

Before we go on, I want to take a moment and share with you five of the most common misconceptions people have about applying a value approach to stock investing. Value investors do not let others make up their mind for them; they absorb the facts and then come to a decision. Independent thinking is a trademark of value investors. Benjamin Graham said: "If you formed a conclusion from the facts and if you know your judgment is sound, act on it—even

though others may hesitate or differ. You're neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right.[4]

Profile: Warren Buffett

With net worth of approximately $52 billion, Buffett is the second-richest person in the world (after Microsoft founder Bill Gates) and is arguably the greatest investor of the past century. The Oracle of Omaha is CEO and the largest shareholder of Berkshire Hathaway. He graduated from the Wharton School and the University of Nebraska, with a master's from Columbia Business School. Among his accomplishments, Buffett earned the only A+ grade ever given by Benjamin Graham in his security analysis class.

Buffett purchases businesses that he can understand, has competent management in place, has an enduring competitive advantage, and will purchase them only at an attractive price. From 1965 to 2006 Berkshire Hathaway grew at an average annual return of 21.4 percent while the S&P 500 index gained 10.4 percent. A $10,000 investment in Berkshire Hathaway in 1965 would now be worth $36 million.

Securities and Exchange Commission (SEC)

the federal agency responsible for oversight of publicly listed corporations, and for enforcing laws and regulations at the federal level.

1. *Much of the information needed to research a stock is too costly, hard to get and difficult to understand*. I am not a big fan of any government agency but I do have to take my hat off to the Securities and Exchange Commission (SEC). Many of the SEC statutes are designed to promote full public disclosure and protect investors from fraud. Because of the SEC, there is an enormous amount of information that publicly traded companies need to disclose.

Most if not all of your research can be had by reading a company's annual report. At the end of a company's fiscal year they send out to all shareholders a report informing them how the company did the past year, what they are planning to do, and the challenges the company will face. The letter is written by the chairman of the board or CEO. Once you get past the charts, graphs, and glossy pictures of smiling employees, you find a wealth of financial information tucked away in the back of the report. This is where you can find the real meat and potatoes of how the company is doing.

Many successful investors recommend you read the past four to five years of a company's annual report as part of your research. You will then be able to see if they kept promises made in previous years, admit to mistakes, and have a consistent message. In other words, since you are a shareholder, you are the real owner of the company and the annual report is the company's way of reporting back to you how well they've done over the past year.

Most annual reports are written in a very friendly and relaxed manner and are not difficult to understand. The great part about annual reports is that they are free. All you need to do is call the company and request it or go to their web site and download or read it. A large percentage of your research can be found by just reading the annual reports. You will be amazed at how few investors read them. In addition to calling the company, there are many free sites on the Web that not only have financial data on a company, but with one click you can compare how a company is performing against its competitors. Today, in only a few hours you can learn more about a company from the comfort of your favorite arm chair that only a decade ago would've cost you thousand of dollars and have taken weeks to gather. Thank the SEC and the Internet for helping create a level playing field for investors allowing them to access information for no cost.

2. *You can't beat the stock market*. Like everything else in life, this statement is both a reality and misconception for different types of investors. If you love hearing hot tips from your doorman who has a son who has a friend who works in the mailroom of ACME Industries, and is certain that they are coming out with a product that will set the world on fire, you don't stand a chance of beating the market. After hearing some analyst from Big Brokerage, Inc. talk up 5 different stocks in fewer than 30 seconds and you can't wait to buy them all, you will have a slim chance of outperforming a money market fund, and you can forget about outperforming the stock market.

If, however, you begin to view stocks as pieces of businesses, purchase quality companies when they are selling for fair prices, ignore the daily gyrations of the stock market, and hold stocks for the long term, then you have a very good chance of beating the market. Fortunes have been made by investors with modest means, who bought quality companies and held on to them for years. Imagine you have invested $1,000 and have divided it equally among the following three companies: Procter & Gamble (makers of Crest toothpaste and dozens of other consumer products), McDonald's (home of the Big Mac), and Pepsico, (maker of Pepsi, Mountain Dew, and other beverage and snack products) on the last day of 1976.

You picked these three companies because they have been in business for years, are market leaders, and you are very familiar with their products. Right

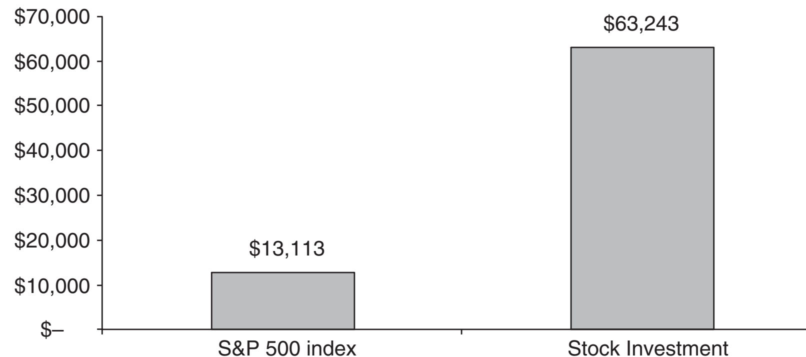


FIGURE 1.1 Results If You Invested $1,000 among Procter & Gamble, McDonald's, and Pepsico on 12/31/76, and Held Them for 30 Years.

after you buy shares in these three companies, you go on a 30-year mission for NASA to explore the planet Saturn and will not be able to change your stock positions or find out how the companies are doing for the next three decades. Upon arriving back on Earth on the last day of 2006, you open up your brokerage statement to find out that your $1,000 is now worth $63,000, easily outperforming the S&P 500 index, which would have grown to only $13,000. You were amply rewarded for investing in companies that you understood and held for the long term, while ignoring the stock market. You can beat the market if you stick to a few of the principles I share with you in this book. See Figure 1.1.

3. *Value investing is all about buying stocks trading at low prices*. Trying to determine if a stock is selling at a good value based on a single number is a mistake most investors and professionals have in common. That's almost like being asked to determine if someone is over or under weight without ever seeing or knowing anything about them. If I told you that my friend Joe weighs 200 pounds and asked you to tell me if he is over or underweight, you would probably ask me a few questions about him. You might ask his age, height, body frame, occupation, how often he exercises, and so on. If you found out that Joe is six feet tall and plays tight end for the New York Jets, you would say he is underweight (average weight for tight ends 2006 NFL draft: 257 lbs.).[5] On the other hand if I told you Joe plays center field for the Boston Red Sox you might conclude that he is the proper weight for his position.

If you try to buy a stock based on the level of the stock price, most likely you will be buying a lot of terrible companies and you will be missing

out on great ones. Berkshire Hathaway Class A (BRKA) shares trade at about $108,000 per share, the most expensive shares traded on U.S. stock exchanges. Yet there are many excellent value investors who are scooping up shares at this price because they determined that the shares are cheap and are really worth between $125,000 and $150,000 per share. According to them, the stock price is not properly valuing the earnings of the company and the stock is trading at a discount to its underlying value.

On the flip side, Bombay Company's (BBA) stock at $1.00 per share may be too high a price for this ailing furniture retailer. Soft sales, terrible earnings, and immense competition might force this company to close its doors as it recently needed to borrow money to pay bills. Simply because it is trading at a low price doesn't make it a value investment. A value investor is never concerned with the price level of a stock. As you have seen, a company can be a great value at $108,000 per share and a terrible value at $1.00. The price of the stock always has to be measured against the worth of the underlying business. It doesn't matter what price the stock is trading for as long as you are getting more in value than what you paid for the stock.

4. *You have to be an accountant to understand a company's financial statements*. If you are the type of investor who buys a stock simply because it is going up or it's in a high flying industry, odds are you never even looked at a company's financial statement. I would wager that most investors who bought stocks in the past decade looked only at the pictures in the company's annual report and never looked at the financials. That should give you some idea as to the advantage you have if you educate yourself to a few simple accounting concepts.

If you have no idea how to read a financial statement, you are not alone. Many business executives I've met have no clue, either. By not knowing basic accounting you will have a very difficult time valuing a business. Accounting is the music of business and by learning how to hum just a few simple tunes, you will avoid overpaying for quality companies and can achieve a higher return on your investments.

It helps to know something about accounting to be a value investor but if you don't, have no fear. If you can figure out how much you made if you bought something for $10 and sold it for $15 and incurred $2 of expenses, you will do alright (a profit of $3).

Most investors don't even bother looking at a company's financial statements because they were never taught what to look for. Thanks once again to the SEC, there are four statements that public companies need to file each quarter: balance sheet, income statement, cash flow statement, and statement

of change in stockholder's equity. These statements give you a snapshot of the company's health. Why four and not one statement? Because four statements allow you to come to a conclusion on the health of the company from four different vantage points. Picture going to a doctor to have your heart checked. The doctor might take your blood pressure, do an EKG. and order a blood workup so that he or she can get a complete rundown on your heart. Each test provides the doctor with valuable information so he or she can make a proper diagnosis.

Financial statements provide that same view to the investor on a company's financial health. A balance sheet shows the financial position (assets, liabilities, and net worth) of a company as of a specific date in time. The income statement shows how much money came in (sales or revenue) and how much was paid out (expenses) for a period of time, usually a full year or quarter. By subtracting the money that came in from the money paid out, you arrive at the amount the company put into its pocket (net profit). The cash flow statement shows where the money came from and where it was spent for that same period of time. And the statement of change in shareholders' equity reports tells you the change in shareholder equity for a certain period of time (you don't need to deal too much with this statement). You certainly don't have to be an accountant to be a value investor and once I show you what to look for on the financial statement, it will be a piece of cake.

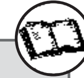
5. *You can make more money investing in growth stocks than value stocks*. Should stock investors favor "value" stocks or "growth" stocks? This argument always strikes me as silly. Isn't every investment about value—buying something below its underlying value? Should we classify someone who buys an item at a price that is greatly above its underlying value a growth investor? The basic difference I see is value investors buy growth companies, too, but they don't want to pay top dollar for them. They take a more conservative and cautious view of the future. On the other hand, growth investors pay up for growth in anticipation that it will continue. Their read of the future is usually more optimistic than value investors'.

Investors have been conditioned to believe (assisted by Wall Street's marketing machine) that investing for growth is the converse of investing for value. Charlie Munger, vice chairman of Berkshire Hathaway, had this to say about this foolish argument: "The whole concept of dividing it up into 'value' and 'growth' strikes me as twaddle. It's convenient for a bunch of pension fund consultants to get fees prattling about and a way for one adviser to distinguish himself from another. But to me, all intelligent investing is value investing."[6]

I couldn't agree more. The goal of investing should be to buy businesses that are selling below their underlying value. A stock market investor should look at the profit margins, operating incomes, and return on equity of a business, regardless of whether it is labeled a "value" or a "growth" stock, and then factor in future earnings growth to determine whether the stock is undervalued or overvalued. If there is a wide gap between your valuation of the business and the value the stock market is giving it, you should buy. That's basically it; value investors try to get more value for their money.

Warren Buffett said: "The two approaches are joined at the hip: growth is always a component in the calculation of value. As long as you are buying great companies for less than their real worth, don't give a darn as to what investing style it is called, just watch your account balance rise over time."[8]

My purpose in this chapter has been to show how the bottom-up and top-down approaches work and why the bottom-up approach makes more sense and carries with it less uncertainty. Forget about trying to predict the future growth of the economy or where interest rates are headed; no one can do that. Instead, spend your time finding good



Profile: Charles Munger

A graduate of Harvard Law School, Munger was given some solid advice by Warren Buffett, who said, "Law was fine as a hobby but he could do better."[7] A few years later, Munger left his law firm and started investing. Today he works with Buffett as vice chairman of Berkshire Hathaway. His net worth is about $1.6 billion.

He guided Buffett from a pure Graham style of investing, which only looked at the financials of a company, to focus more on the quality of the business. Buffett gives him the credit for much of the enormous success of Berkshire Hathaway.

Munger is a worthwhile model for how value investing can work. First, he limits his investments to businesses with a sustainable competitive advantage; he buys them at a fair price; and finally, he believes that a portfolio of three companies is plenty of diversification. Munger is content to invest a lot of capital in very few holdings and hold those positions for a long time.

His extreme patience combined with extreme decisiveness has paid off handsomely. From 1962 to 1975, Munger's partnership returned a compound annual return of 13.7 percent, after fees, versus 5.0 percent for the Dow Jones Industrial Average. During that time, a $100,000 investment in the partnership would have grown to $530,745 versus $188,565 if it had been invested in the Dow Jones Industrial Average.

businesses selling at attractive prices. By the time you finish this book, you will have all the tools you need to find them.

In the next chapter I show you why value investing is the most logical approach to take when investing in the stock market and how academics still don't get it.

Key Points

1. Bottom-up investing makes more sense than top-down investing. It places unknown factors within your control.
2. Independent thinking is a trademark of value investment, as exemplified by Warren Buffett, today's best-known and greatest value investor.
3. The goal of investing should be to buy businesses that are selling below their underlying value.