Chapter 1

An Investor's Guide to Value Investing

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In This Chapter

- Recognizing the value investing style — what it *is* and *isn't*
- Bottom-line value investing principles
- Comparing value investing to other investing styles
- Deciding if you're a value investor

No doubt, if you're reading *Value Investing For Dummies*, somewhere during your investing career you heard something about value investing. You heard about it from your retired next-door neighbor. You heard about it as "what Warren Buffett does." You saw a mutual fund describe itself as a "value-oriented" fund.

You have a pretty good idea what the word "value" means in ordinary English. It's not an altogether precise concept; the *Random House Dictionary of the English Language* defines it as the "relative worth, merit, or importance" of something. Okay, fine. But how does that apply to investing? What *is* value investing, anyway?

This chapter answers that question. The rest of this book gives you the background, tools, and thought processes to do it.

Definitions? No Two Are Alike

Perhaps you've asked around — to friends, experienced investors, investing professionals — for definitions of "value investing." You probably got a lot of different answers. Those answers perhaps included phrases like "conservative," "long-term oriented," "the opposite of growth," "the Buffett approach," "buying stocks with a low P/E," "buying stuff that's cheap," or "buying stocks that nobody wants."

None of these is "it" entirely, but it turns out they are all *part* of it.

All, except the "opposite of growth," that is — and we'll get to that.

Value investing is an investing approach and style blending many principles of business and financial analysis to arrive at good investing decisions. This, too, is an imprecise definition, but it lays the groundwork for the more precise principles and style points that follow.

What Is Value Investing?

Toward a definition, here's one you may have read in the first edition of *Value Investing For Dummies*. It still works:

> *Value investing is buying shares of a business as though you were buying the business itself. Value investors emphasize the intrinsic value of assets and current and future profits, and pay a price equal to or less than that value.*

You'll quickly note key phrases: "buying a business," "intrinsic value," and "pay a price equal to or less than that value." These are explicit tenets of the value investing approach, and underlying them all is the notion of conscious appraisal — that is, the idea of a rigorous and deliberate attempt to measure business value.

You'll also notice that "price" enters the appraisal, but not until the end. Value investors only go to the stock market to buy their shares of the business. Value investors don't look at the market as an indicator of whether to invest.

With this definition of value investing as an appetizer, here's a "main course" of value investing principles.

Buying a business

If you take nothing else away from reading this book, take away the thought process that investing in stocks is *really* (or should be) like buying a business.

That concept shouldn't really be that hard to grasp — after all, when you buy shares, you *are* buying a *portion* of a business, albeit in most cases a small one. This isn't to say you have to buy a larger share of the business to think of your investment as buying a business — this principle applies even if you're buying a single share.

Put differently, whether it's an espresso cart or 1,000 shares of Starbucks you want to buy, the purchase is analyzed the same way. Treat the investment as

if you were buying the business — the *whole* business. By buying shares, you're committing capital to that enterprise in exchange for an eventual healthy and appropriate return on that investment.

Now, some of you who got caught in the tech boom and bust may think you did exactly that. You followed a company and its story. The products were "killer apps" and everything the company did made headlines. Everybody wanted to own its products or work for the company. So you bought shares.

But did you look at business fundamentals? Intrinsic value of assets and future profit prospects? Did you understand their strategy and competitive advantages? Did you do your homework to assess whether the stock price was at or below your appraisal? Likely not. That's the difference between value investing and most other forms of investing.

Making a conscious appraisal

If you were interested in buying a business for yourself and thought the corner hardware store looked attractive, how much would you be willing to pay for it? You would likely be influenced by the sale price of other hardware stores and by opinions shared by neighbors and other customers. But you would still center your attention on the intrinsic economic value — the worth and profit-generation potential — of that business, and a determination of whether that worth and profit justified the price, before you committed your hard-earned dough.

Value investors like to refer to this as an *appraisal* of the business. The business would be appraised just as one would appraise a piece of property or a prized antique. In fact, a business appraisal is deeper and more systematic than either of those two examples, as value is assigned to property or antiques mainly by looking at the market and seeing what other houses or vases of similar quality sold for. In the investing arena, there's so much more to go on. There are real facts and figures, all publicly available, upon which the investor can base a true numbers appraisal, an appraisal of *intrinsic* value, not just the market price.

Appraising the value, relating the value to the price, and looking for good bargains captures the essence of the value approach.

Beyond investment analysis

You may be inclined to ask, "Isn't value investing merely 'souped up' investment analysis?" The kind of analysis done by professional Wall Street analysts?

It's a good question, and becoming a better one as the tech boom and its excesses fade into history. Analysts in those days were too focused on stock prices and the general "buzz" about an industry, and were often too influenced by their peers. Witness the hype about Amazon.com, which turned out to be far too optimistic (and indeed at the time of this writing, still is).

Basic investment analysis should start with an analysis of business fundamentals — the metrics and measures that define business performance, like profitability, productivity, and capital structure. But it needs to go further to be blended with the "story" to determine whether the fundamentals will hold up, or better yet, improve. The "boom years" investment analysis tended to overlook the fundamentals altogether, marching straight into the story. Some analysts today tend to focus too much on fundamentals, like return on equity (ROE) or "free cash flow," without understanding the story.

The value investor gets good at understanding and blending both — the fundamentals, the story, and how the two work together to define a really great business.

Chapters 6–10 dig into the mechanics of financial statements and fundamentals, while Chapters 11–15 explore how financial and marketplace fundamentals work together to define "intrinsic" and "strategic" values of a business. At the end of the day, your appraisal will touch all of these bases.

Get used to this idea: Adopting the value investing approach means *becoming your own investment analyst*. You may read the work of others, but you'll incorporate it into your own analysis and investing decision. As your own analyst, the pay can be good, but isn't guaranteed — it's clearly a "pay-for-performance" proposition. One thing for certain: You'll never have to buy or dry clean a Brooks Brothers suit!

Ignoring the market

How can you spot the value investor at a cocktail party? Easy. He's the only one talking about an actual company while all others stand around discussing the stock market.

The bird of a value-investing feather is easily spotted. Focusing on the company itself, *not* on the market is a consistent value investing attribute. As a general rule, value investors ignore the market and couldn't care less what the Dow or NASDAQ do on a particular day. They tune out the brokers, advisers, commentators, chat-roomers, and friends (insofar as investment advice is concerned, anyway). They may, however, listen to folks in the industry, customers, or people who know a lot about competitors.

Value investors have a long-term focus. And if a value investor has done his or her homework right, what the market does to his stocks on a daily basis is irrelevant. If the company has value but the stock went down on Tuesday, a value investor feels that it's probably a result of the market misreading the company's value.

Now, to be sure, external factors can affect stock prices. Interest rates, in particular, can affect not only stock prices but also the true intrinsic value of companies, as the cost of capital rises and falls and the value of alternative investments increases (there's more in Chapters 3 and 12). So while it makes sense to pay some attention to the markets, especially in the long term, daily fluctuations, particularly when they are *just* that, should be ignored. The value investor can wait anywhere from a few years to forever for her investments to mature. The value investor looks for a good price with respect to value, but doesn't try to time the market. If the value is there and the price is right, it will probably be right tomorrow, too.

Some sage advice from Warren Buffett: "For some reason, people take their cues from price action rather than from values. What doesn't work is when you start doing things that you don't understand or because they worked last week for somebody else. The dumbest reason in the world to buy a stock is because it's going up."

Value Investing Is Not...

Following the same thread of logic that holds that "we all learn best from our mistakes," sometimes the best way to define what something *is* is to define what it *isn't.* Or at least, to show why it isn't constrained to a limiting attribute like "value investing is long-term investing."

One at a time...

Not just conservative

Most people equate the concept of "value" investing with "conservative" investing. Conservative investors focus on minimizing risk, and in many cases, maximizing short-term cash returns from investments.

Fixed income investments — such as bonds and money market funds and stocks in placid sectors like utilities and insurance companies — meet the "conservative" criteria, and there is nothing wrong with these investments. Indeed, most, but not all fit "value" criteria as well — strong intrinsic value, steady, predictable returns — at a reasonable price.

But while most conservative investments are value investments, not all value investments are conservative. It is possible to view a company like Starbucks, with incredibly strong brand features, strategic position, and growth potential, especially ten years ago, as a value investment. A conservative investment, no, but a value investment, quite possibly yes.

Not just long term

Most value investments *are* long term. In fact, the Buffettonian view is to "hold forever" and look for businesses that you would *want* to hold forever. That's part of what makes them a good value.

But not all long-term investments are good values, and not all value investments are long term. Indeed, as business cycles shorten today, what is excellent today may look like a flash in the pan as technologies used in business and marketplace acceptance change.

Buffett deals with this problem by simply avoiding technology makers and heavily technology driven companies, for example, because (1) technology changes and (2) he doesn't understand technology in the first place. But even stable businesses see their products change and change ever more quickly. You once could buy only one "flavor" of Tide detergent, but now there are dozens, and they change all the time. And it isn't just all powder — there are liquids, concentrated liquids — you get the idea.

So when buying a business, it's good to look long term, but you must also realize that businesses and their markets change, and you should always be prepared to sell a business if assumptions change. That said, most value investments — if they *are* truly value investments — should be good to hold onto for more than a year, which is the IRS definition of "long term."

Not just low P/E

Oil companies, banks, food producers, and steel companies all have had P/E ratios (price-to-earnings) below market averages. But does that mean they are good values? Sometimes, but not always. Bethlehem Steel or — ahem — Enron all traded at one time or another with low P/Es. But the earnings, and the business itself, turned out not to be sustainable.

So while low P/E can be part of the investing equation, especially when deciding when the stock price is right, it is far from the whole story.

Not the "opposite of growth"

"Stock ABC is a growth stock, and stock XYZ is a value stock." You hear that all the time, and you'll also hear it about mutual funds, which have been neatly divvied up by stock and fund information portal Morningstar (www.morningstar.com) into neat little boxes tagged as "growth," "value," and "blend."

So value stocks aren't supposed to grow? Well, some, like your local electric utility, may prosper just fine on the business they have, and may pay you handsome returns in the form of dividends. But for most companies, growth is an integral part of the value of the business — it creates the return you desire as an investor.

So this treatment of value investing places growth in the center of the "value" stage. It is the potential for growth that defines Starbucks and its brethren as good values — the current assets and perhaps even current business levels alone don't justify the price. Indeed, this is what separates early value investing, as practiced and preached by patriarch Ben Graham, from the more recent views practiced by Buffett and many of his current disciples: Growth creates value. More on this in Chapter 3 and throughout the book.

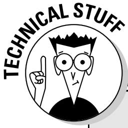
Cheap is a relative term

Above all, value investors seek to buy businesses at or below their appraised value. Why? Not just because they like to get a good deal — it's to provide a *margin of safety*.

Because any business appraisal is imprecise at best, the value investor likes to give a cushion for error, a cushion just in case things don't turn out exactly as assessed.

So does that mean that a value investor always buys a stock below its highest price? Usually, but not always. Does a value investor "bottom fish" for the lowest 52-week price? Usually not. Why? Because it's all about price relative to value. A stock at a 52-week low may have serious flaws in its business or marketplace acceptance.

And value investors have been known to buy stocks at 52-week highs — if (and *only* if) even that price understated their value appraisal. Doesn't happen often, but knowing that it does happens reinforces the true value concept.



Evaluating your values

Value can be defined in many, many ways. Kind of like *pleasure*, the term probably means something different to each one of us. Investors of all feathers attach different meanings — a day trader can look at a small uptick and call a stock a value at a current price. Even among value investors, the definition of the word may vary. Some additional perspective may be in order. Timothy Vick, in his book *Wall Street on Sale* (McGraw-Hill, 1999) provides a few definitions of value that are recognized by U.S. civil law:

- **Fair market value** is whatever someone will be willing to pay for a similar asset — a.k.a. market value.
- **Book value** is a company's net worth on an *accounting* basis, which may differ from true financial value because of accounting rules, timing, and so on.
- **Liquidation value** (which is very subjective and hard to predict) is what a company would be worth if all the assets were sold.
- **Intrinsic value** is "what an appraiser could conclude a business is worth after undertaking an analysis of the company's financial position," based on assets, income, and potential growth. The value investor looks to establish intrinsic value. Only in some situations will the value investor take book or liquidation value into account.

Comparing the Value Investing Style to Others

Value investing is more than just a set of rules or guiding principles; it is an investing *style*. It is an approach; a thought process; a "school" of investing; a way of investing life that governs investing behavior for at least a portion of an investor's portfolio. Just like with the definition of value investing itself, it helps to contrast the value investing style with other popular styles you may have come across.

Throughout market history, much has been made of the different approaches to investing. There are fundamental and technical analysis, momentum investing, trading, day trading, growth investing, income investing, and speculating. And there's story or concept investing, where the investor goes with whatever fad or technology is popular or *sounds* popular, without regard to intrinsic value *or* price. Add to these the academic treatments of security valuation and portfolio theory that may make it as far as institutional trading desks but seldom find their way to individual's bookshelves.

In words that Abraham Lincoln may have used, all styles make money some of the time, but no one style makes money all of the time. Each style suggests a different approach to markets, the valuation of companies, and the valuation of stocks.

Table 1-1 summarizes the differences among various investing styles.

Table 1-1 Comparing Investing Styles

Investing Style	*Stock Price Driven By*	*Relationship between Price and Value*	*Buy Based On*	*Is It Value Investing?*
Funda-mental	Financials, earnings, dividends	Price will *eventually* equal value	Positive or improving fundamentals	Yes. Value investors look at fun-damentals, then price.
Technical	Patterns, trends, market psychology	Not related	Buy signals	No
Story	Company story, market psychology	Not related	Timeliness	Can be part of intangi-bles of value investing
Momentum	Price trend, trend strength	Not related	Trend strength, relative strength	No
Growth	Earnings growth, growth prospects	Value will eventually equal price	Sustained or improving growth prospects	Yes. Growth is part of the value equation.
Income	Cash yield vs. alternatives	Price should equal value	Yield vs. alternatives, risk profile	Sometimes. Income can be part of the value equation.
Speculation	Events, probability of occurrence	Usually none	Reward vs. risk	No
Value	Intrinsic and strategic value	Price should be at or below value	Value obtained for price	Of course

The Value Investing Style

We've stated it before: Value investing is a style of investing. It's an *approach* to investing. You, as an investor, will adopt some of the principles presented here, but not all of them. You will develop a style and system that works for you, and the knowledge available in the rest of this book will contribute to your style.

No magic formulas

Some people buy and read investing books looking for a magic formula that guarantees success. Buy when a stock crosses its 50-day moving average and you'll profit every time, or buy when the PEG (covered in Chapter 16) is less than 1.0.

Value investing isn't quite that simple. There are so many elements and nuances that go into a company's business that you can't know them all, let alone figure out how to weigh them in your model. So rather than a recipe for success, you will instead have a list of ingredients that should be in every dish. But the art of cooking it up into a suitable value investment is up to you.

Like all other investing approaches, value investing is both art and science. It is more scientific and methodical than some approaches, but it is by no means completely formulaic. Why, if it were, everyone would use the same formula, and there would be no reason for a market! Stock prices would simply equal formulaic value. Wouldn't that be boring?

Always do due diligence

It can't be repeated enough: The value investor must do the numbers and work to understand a company's value. Although, as explained in Chapter 5, there are information sources and services that do some of the number crunching, you're not relieved of the duty of looking at, interpreting, and understanding the results. Diligent value investors review the facts and don't act until they're confident in their understanding of the company, its value, and the relation between value and price.

Nipping closely at the heels of diligence is *discipline.* The value investor does the work, applies sound judgment, and patiently waits for the right price. That is what separates the masters like Buffett from the rest.

Investing is no more than the allocation of capital for use by an enterprise with the idea of achieving a suitable return. He who allocates capital best wins!

A quest for consistency

While value investors have varying approaches to risk, some willing to accept greater risk for greater rewards, almost all like a degree of consistency in returns, profitability, growth, asset value, management effectiveness, customer base, supply chain, and most other aspects of the business. It's the same consistency you'd strive for if you bought that espresso cart or hardware store yourself.

Before agreeing to buy that hardware store, you'd probably want to know that the customer base is stable and that income flows are steady *or at least predictable*. If that's not the case, you would need to have a certain amount of additional capital to absorb the variations. Perhaps you'd need more for more advertising or promotion to bolster the customer base.

In short, there would be an uncertainty in the business, which, from the owner's point of view, translates to *risk*. The presence of risk requires additional capital and causes greater doubt about the success of the investment for you or any other investors in the business. As a result, the potential return required to accept this risk and make you, the investor, look the other way is greater.

The value investor looks for consistency in an attempt to minimize risk and provide a margin of safety for his or her investment. This is not to say the value investor *won't* invest in a risky enterprise; it's just to say that the price paid for earnings potential must correctly reflect the risk. Consistency need not be absolute, but predictable performance is important.

Focus on intangibles

As you'll see in detail especially in Chapter 14, today's value investors are as intently focused on business intangibles, like brand and customer loyalty, as on the "hard" financials. It's all about looking at what's behind the numbers, and moreover, what will create tangible value in the future.

So a look at the market or markets in which the company operates is important. Looking at products, market position, brand, public perception, customers and customer perception, supply chain, leadership, opinions, and a host of others factors is important.

Provide a margin of safety

We mentioned the idea of buying a company at a bargain price to achieve a margin of safety; that is, to provide a buffer if business events don't turn out exactly as predicted (and they won't). The value investing style calls for building in margins of safety by buying at a reasonable price. The style also suggests finding margins of safety within the business itself, for instance, so-called "moats" or competitive advantages that differentiate the business from its competitors. Finally, a large cash hoard or the absence of debt offers a financial margin of safety.

It's not about diversification

You probably have heard on every talk show or read in every investing magazine that the key to investing success is to diversify. Diversification provides safety in numbers and avoids the eggs-in-one-basket syndrome, so it protects the value of a portfolio.

Well, yes, there's some truth to that. But the masters of value investing have shown that diversification only serves to dilute returns. If you're doing the value investing thing right, *you are picking the right companies at the right price*, so there's no need to provide this extra insurance. In fact, over-diversification only serves to dilute returns. That said, perhaps diversification isn't a bad idea until you prove yourself a *good* value investor. The point is that, somewhat counter to the conservative image, diversification *per se* is not a value investing technique. More about this is found in Chapter 4.

A blended approach

If you decide to take up the value investing approach, know that it doesn't have to be an all-or-nothing commitment. The value investing approach should serve you well if you use it for, say, 80 percent or 90 percent of your stock portfolio. Be diligent, select the stocks, and sock them away for the long term as a portfolio foundation. But that shouldn't exclude the occasional possibility of trying to enhance portfolio returns by using more aggressive short-term tactics, like buying call options.

These tactics work faster than traditional value investments, which may require years for the fruits to ripen. Of course, this doesn't mean taking unnecessary or silly risks; rather, it means that sometimes investments can perform well based on something other than long-term intrinsic value. It doesn't hurt to try to capitalize on that, so long as you understand the risks

and are willing to face losses. In fact, it's best to think of a short-term trading opportunity as simply a very short-term value investment — a stock, for instance, is very temporarily on sale relative to its true value.

Likewise, it's perfectly okay to put capital away for short-term fixed returns. You don't have to work hard on "due diligence" for all parts of your portfolio at the same time.

A solid base in bonds, money market funds, or similar investments will produce returns and allow you to focus your energy on the parts of your portfolio you *do* want to manage more actively.

You don't have to use the value investing approach for *all* your investments. Depending on your goals, it's okay to mix investing styles.

Are You a Value Investor?

By now, you've probably asked yourself the questions, "Am I patient enough?" "Do I have what takes?" "Can I do the numbers stuff?" "I'm not sure I was cut out to be an entrepreneur — how to I appraise a business?" Here are seven character traits found in most value investors:

- **Bargain hunter:** Do you check the price of the hotel across the street before you check into your chosen hotel? Do you study detailed automobile specifications and prices before you buy? Do you look at different boxes of detergent to see how much better the deal is on the 67-ounce size versus the 43-ounce size? You have a key trait of a value investor, although we continue to be surprised at otherwise frugal folks who are willing to throw investment dollars at almost anything.
- **Do it yourselfer:** Value investors want to check the numbers themselves and build their own assessments. By doing so, they develop a better understanding of the company and its fundamentals.
- **Like margins of safety:** People who actually slow down when it rains are more likely to be better value investors.
- **Long-term focus:** Value investors would rather make a lot of money slowly than a little flashy money in one day. Sort of like going for marriage instead of one-night stands.
- **Business, not price oriented:** The value investor focuses on the underlying business, not the price or superficial image. They look under the hood instead of at the trim. Value investing is sometimes called inside-out investing.

- **Numbers oriented:** Not advanced mathematics, mind you, but you can't get completely away from the numbers. Value investors are concerned about company business fundamentals and performance. For those who don't like numbers, fortunately there are software packages that do some of the computation and preparation for you. And there are screeners to semi-automate company selection. Find out more in Chapter 5.
- **Contrarian:** Value investors are not crowd followers! Value investors stay away from what's exciting and hip quite purposefully. By definition, popular stocks aren't normally bargains.

Value investors like to make lists of selection criteria and then choose companies that match the greatest number of them. You can do the same with this list. To be a good value investor, you certainly don't need to excel in every trait! But you'll find that five or six out of the seven listed here would be a big help.