



Value Investing – An investment strategy that created wealth for investors over many decades had been questioned as ‘visibly cheap’ stocks continue to underperform the ‘seemingly expensive’ ones

VALUE RE-SERVED!

The tennis season of 2017 is considered to be one of the greatest comeback seasons in the history of the sport. It saw the return of Roger Federer (RF) from a disappointing and injury shortened 2016. In fact, Federer was undergoing a difficult phase for the preceding 5 years as well. From 2003 to 2010, he was almost unbeatable, winning Wimbledon 6 times, the US Open 5 times, 4 Australian Opens and a French Open. For the next six years, Federer won only one major tournament in 2012. He did reach the semi-finals or the finals in some tournaments, but it was not good enough for RF fans, who count a good year in terms of number of grand slams won. At 36 years of age and suffering multiple injuries, most thought it was the end of Federer.

In 2017, Federer proved his sceptics wrong. He won two majors – the Australian Open and the Wimbledon Championships, marking the first season since 2009 in which he won multiple majors. Federer won a total of seven titles in the season, the most since 2007, and with a win-loss record of 54–5, his winning percentage was the highest since 2006. Audiences noticed that Federer was playing with a new, larger racquet and he had changed the way he played backhand. He was attacking with single handed backhand top spin instead of a more defensive slice. The improved backhand aided better footwork which in turn put him in a better position to hit his forehand as well. Federer acknowledged this as being an important contributing factor for his success. While Federer was always a great player with many tools in his arsenal to destroy competition, he worked to acquire a new one aiding a strong comeback.

Why am I talking about this? Value investing as an investment strategy has come under question for the past few years now. Some believe it is never coming back. An investment strategy that created wealth for investors over many decades is been questioned as ‘visibly cheap’ stocks continue to underperform the ‘seemingly expensive’ ones. For a while



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temporarily”

now, the ‘value’ factor is underperforming the ‘quality’ factor. There are many reasons sighted for this: easy money, low interest rates, absence of high growth, new digital economy, business disruption etc.

I believe value investors will make a strong comeback in the coming years. Bold statement? Probably Yes! The current phase in the equity markets will provide a great shopping opportunity for value investors and is expected to sow the seeds of healthy returns for years to come. I am also saying there will be different tools used to hunt value (a new racquet or a new shot). Value investing over the past four decades has evolved to improve investment decision by adding new tools or approaches that adapt to the business conditions.

THE SUPER INVESTORS OF GRAHAM-AND-DODDSVILLE

Most of the time, when I talk to investors about value investing, they still picture buying a company with low price-to-book ratio or a low price-to-earnings ratio or (at the most) a company with good dividend yield. While these are short cuts to assess a relative value of a company, value investing is not about buying the cheapest companies on these parameters. Value Investing is a broader philosophy which involves buying companies at a price which is lower than their intrinsic value. For most people this is common sense. Why should one buy a company or an asset *higher* than its intrinsic value anyway? If one does, it is mainly due to the greater fool theory that someone else will pay a higher price. Hence the statement by Charlie Munger “All sensible investing is value investing.”

Benjamin Graham provided the foundation for value investing by articulating the difference between an investor and a speculator. And further by classifying investors into conservative and enterprising investors. He provided the framework for value investing by introducing the concept of Mr. Market and Margin of safety. However, the advice on what multiples to pay (whether P/E or P/B) were based on market conditions during the 1930s and 1940s and the type of businesses traded during those times. Graham’s students actually evolved their own changes to these criteria over the years. Let’s take the examples cited in the famous speech by Warren Buffet in 1984 titled “the super investors of Graham and Doddsville”.



Intrinsic value considers many different parameters and uses them to put the right value to the business

Walter Schloss
Sequoia Fund
Perimeter Inv

Tweedy Browne
Charlie Munger
The Washington Post Co. Fund

Buffett Partnership
Pacific Partners
FMC Corp.

All these are value investors following the philosophy outlined by Graham and Dodd and have delivered superior returns on their assets. They all gave significant importance to evaluating risk and adhered to the Graham's first principle: Never lose money. Investors can go wrong in forecasting the future and hence all of them talk about margin of safety. And all of them believe markets are inefficient, so current prices do not correctly reflect the intrinsic value of companies making one beat the market. The core ingredients remain the same.

However, all except Walter Schloss in the above list, put a different angle to the pure value parameters which were suggested by Graham (and Dodd); and tweaked the value investing style to improve their investment decisions.

EVOLUTION

You will find Tweedy Brown in the investor list of Google; and Warren Buffett (Berkshire Hathaway) in shareholder list of Amazon. Value investor in a couple of FAANG stocks?! Have these investors changed their strategies? No. They insist that Google and Amazon were bought only when they fit into their criteria as a value investor and they have justified the same in their letters. It is however important to understand that value investors evolved their analysis and valuation tools. Let's clear some myths about value investing:

Myth 1: Value investing focusses only on assets and current earnings

Value investors focus on intrinsic value rather than just asset value or earnings multiple. Asset light companies don't necessarily fit asset value multiples but can be great cashflow businesses. Also, cyclicals look expensive on earnings basis during downturns even when their stock prices are at a trough. They look cheap at the top of the cycle with the best earnings. Intrinsic value considers many different parameters and uses them to put the right value to the business. Private market value is another method used by many

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value investors. A similar transaction in the industry by M&A or private equity funding can give the investor a peek into what private market value a company can hold. In the current environment when businesses are under lockdown, there are no earnings, so investors have to use other valuation methods.

Myth 2: Value investing implies buying any business that is cheap

Graham proposed the “Cigar Butt” approach wherein one buys discarded stocks that were trading below their net current assets. This is like picking up a Cigar someone has discarded but still has a few puffs left in it. For someone who picks up such an investment, those few puffs are essentially free. One would make a value arbitrage if the stock moves up or the company goes into liquidation. The reason one would find such opportunities in normal times was due to company having unattractive business fundamentals. Value investor have moved away from this approach as these businesses would frequently keep running into problems and don’t deliver much upside. Value investors moved to buying good businesses at a fair price rather than bad businesses at attractive prices. Essentially value investors moved from “bankrupt business” to “businesses which would keep going”. Value investors also moved from “companies that investors don’t like” to “companies that investors don’t like temporarily”. Often good businesses run into trouble. If these issues are ascertained to be short term in nature, the stock would be available at an attractive price.

Myth 3: Value investing doesn’t focus on future growth

Growth creates value; but it is difficult to accurately make long term forecast about business growth rates. Value investing draws comfort in deriving a large portion of total value of the company from its present operations. Benjamin Graham has written in the book, *The Intelligent Investor*, “the growth stock approach may supply as dependable margin of safety as is found in the ordinary investment – provided the calculation of the future is conservatively made, and provided it shows a satisfactory margin in relation to the price paid”.

Value investing has evolved to shore up its weaknesses and increase its circle of competence

Myth 4: Value investors ignore intangibles

Yes, this used to be true. Value investors did prefer companies with tangible assets as they looked to reduce the risk of downside due to liquidation. However, it is not so now. Investors like businesses that deliver good compounding over long term. But a good business will often attract competition and the superior returns will deteriorate and ultimately disappear. Hence value investing looks for businesses that have an 'economic moat'; those businesses that can protect their turf better and have a competitive advantage. The sources of moat are often intangibles and investors value those while examining the companies and provide for appropriate valuation.

CONCLUSION

As mentioned earlier, among the super-investors mentioned in Buffett's speech in 1984, Walter Schloss was the one who followed the purist approach of buying companies below book value. He delivered good returns to his investors for decades. In one of the interviews he accepted that "... We like to own stocks that we think have downside protection. The trouble is that many might not have too much upside potential". Value investing has evolved to shore up its weaknesses and increase its circle of competence. It doesn't change the basic philosophy of buying a company below its intrinsic value, it just gets better at it.

**NIMESH CHANDAN****HEAD – INVESTMENTS, EQUITIES
CANARA ROBECO**

Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

ABOUT STOIC INVESTOR:

The word “Stoic” is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the “Stoic investor” as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).

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