VALUE INVESTING

STRATEGY

THE RETIREMENT GROUP LLC

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Contents

What is Value Investing?

Value investing is a strong, long-term investment strategy that is often misunderstood. Many of the greatest investors that have ever lived have employed some form of value investing as an integral part of their overall stock investing strategy. However, value investing is not a rigid strategy where you have to follow a strict set of guidelines. Like many financial terms and concepts, there are many nuances that pertain to the general concept of investing for value in common stocks.

There is some theoretical common ground that applies to all value investing approaches. At the core, value investors are looking for investment opportunities in companies that they believe the market is currently undervaluing. Additionally, most value investing strategies attempt to exploit arbitrage that occasionally results between a company's stock price and its true underlying fundamental value.

This article will present value investing strategies that primarily focus on investing in dividend growth stocks. Although all value investing implies investing in a business below its true worth, the calculation of fair value can differ significantly between various types of common stocks. For example, a fast-growing true growth stock will command a different level of fair valuation than a slower growing dividend paying company. Although the underlying principle of value applies to both, the calculation of fair value will be materially different.

Long-Term View

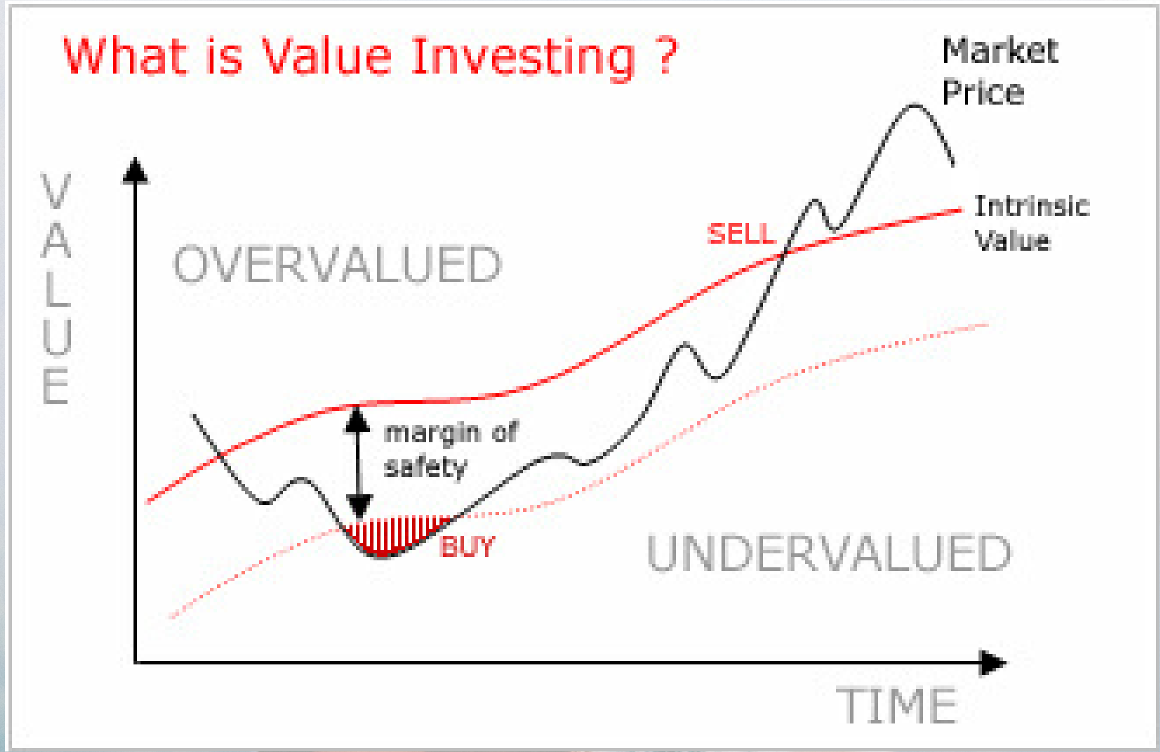
One important attribute shared by most value investing approaches is the perspective of taking a long-term view. This is critically important, because it is common for undervalued common stocks to not perform well over the short run. This is typically the case because many undervalued investment opportunities will not be found in popular companies (those that carry a wide following). Common sense dictates that stocks only tend to become undervalued when they are temporarily overlooked or unpopular. It is generally this unpopularity that creates the short-term discrepancy between fundamental value and stock price.

The greatest success derived from value investing happens when the company's stock price is dropping even when the fundamentals of the company continue to remain strong. Therefore, the key to implementing a profitable value investing transaction is to learn to focus on and trust the fundamentals supporting the business. In the same context, this means adopting the conviction to be skeptical, and even the willingness to ignore poor short-term price action. Accomplished value investors understand that stock prices can lie, at least over the short run. But more importantly, accomplished value investors also understand that in the long run, fundamentals matter most. Short run fluctuations in stock prices are heavily influenced by speculation and investor sentiment. Whereas in the long run, the market can compare these speculations against what actually happened and can then more accurately price the company and better align market price with true intrinsic price.

For example, Joel Greenblatt is a very successful investor who employs a value strategy. His formulaic investment method, on average, underperforms the market in 5 out of every 12 months, 1 year out of every 4 years, and for 2 years in a row every 6 years. There are even periods of time where Greenblatt underperformed the market for 3 years in a row[1]. Yet from 1985-2006, Greenblatt is reported to have earned an annualized return of 40.2%! So despite turbulence in the short term, and occasionally spanning multiple years, a value investing strategy is historically proven to be successful if you can manage to stick with it over the long run. Consequently, successful value investing requires a level of patience that unfortunately many short-term oriented investors lack. The rewards from investing in a truly undervalued stock can produce powerful long-term returns for the rational value investor who is capable of practicing intelligent patience. These powerful long-term returns also come at a lower risk.

Margin of Safety

Value investing does not eliminate all the risk or risks associated with common stock investing. But, if engaged in properly, value investing does significantly mitigate or reduce the risks to a more than acceptable level. This last point also applies to investing in the same individual stock at different levels of valuation. In other words, if you overpay for even the best company, you thereby add a level of risk that is not innate to the fundamental strength of the business itself. Investing in the same company when it is undervalued will reduce the risk of owning it, and simultaneously add a stimulus of sorts to your future long-term results.



The common intuition follows that a higher reward requires higher risk. As explained, this is not the case with value investing though. As a result of purchasing a strong company at a discounted price, eventually the market should realize the mispricing and the stock price should appreciate. The probability that a fundamentally sound company already priced at a bargain will continue to drop in market value over the long run is slim. So another key concept of value investing is this idea of a “margin of safety”.

Source: https://www.google.com/url?q=http://easy-stock-market.com/value-investing&sa=D&ust=1572459459899000&usg=AFQjCNGiWVaY4_ZhEri1K0RUjalb7fhhuQ

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Application of the Value Investing Strategy

In their research paper titled "Contrarian Investments, Extrapolation and Risk", Josef Lakonishok, Robert Vishny, and Andrei Shliefer looked to analyze the historical results of a value investing approach. The table above highlights the data from one of their studies which explored the question of whether or not value investing involved more risk.

Table 9: Average One-Month Investment Returns in Relation to Price as a Percentage of Book Value in the Worst and Best Stock Market Months, April 1968 – April 1990

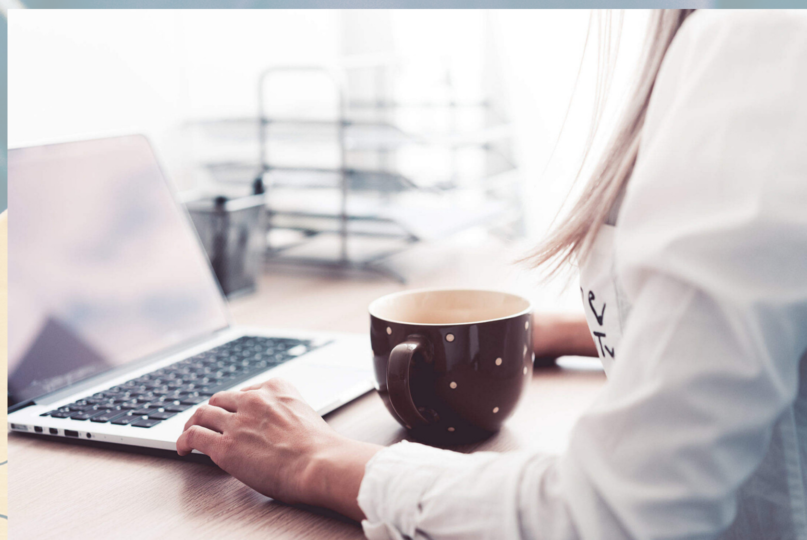
	Price as a Percentage of Book Value Decile									
	(Highest Price as a Percentage of Book Value)					(Lowest Price as a Percentage of Book Value)				
	1	2	3	4	5	6	7	8	9	10
Worst 25 months in the stock market	(11.2%)	(11.0%)	(10.4%)	(10.0%)	(9.7%)	(9.1%)	(9.3%)	(9.2%)	(9.8%)	(10.2%)
Next worst 88 months in the stock market when the stock market declined	(2.9)	(2.8)	(2.6)	(2.5)	(2.3)	(2.0)	(2.1)	(2.0)	(1.8)	(2.2)
Best 25 months in the stock market	11.4	11.4	11.9	11.3	11.2	11.3	11.8	12.6	13.3	14.8
Next best 122 months in the stock market when the stock market increased	3.8	4.0	3.9	3.7	3.6	3.7	3.8	3.7	3.8	3.9

All stocks on the NYSE were sorted into one of ten groups depending on the ratio of market price to book value from 1968-1990. Then the returns were calculated during different times of the market. If a value investing strategy earned higher returns due to increased risk, then what we should see in the data above is that in the worst months of the market, the value approach should perform worse because of the greater downside risk. But what we can see from the data is that the companies that had a lower market price as a percentage of book value (an undervalued stock) had the best returns of any group in both the worst 25 months of the stock market and next worst 88 months in addition to the best months.

How to Benefit From Market Corrections

When a stock is overvalued, it will inevitably revert back into alignment with its fundamental value. Unfortunately, the precise timing of that movement is unpredictable, and can take longer than many people expect. This principle can cause investors in overvalued stocks to lose capital long-term, even when the company remains fundamentally strong. In contrast, when a stock is undervalued,

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."
- Warren Buffet



It will also inevitably revert back into alignment with its true worth in the long run. Regardless, the value investor not only receives financial rewards from the fundamental strength and/or growth produced by the company's business results, they also receive accelerated rewards from future P/E ratio expansion.

Source: https://www.google.com/url q=http://www.berkshirehathaway.com/letters/1989.html&sa=D&ust=1572459459901000&usg=AFQjCNGHL4bG_WnGGI7h7Kafa3UJNduHSA

THE SUCCESSFUL VALUE INVESTOR

There is a large misconception and even criticism that alleges that value investors do not care about capital appreciation or total return. Although it is true that accomplished value investors will ignore short-term price volatility (losses), this does not mean that they don't care about making a profit. It does mean that they do not worry very much about short-term price volatility, but only when they have determined through research that it is unjustified.

Accomplished value investors understand that long-term investment results are fundamentally linked to the success of the business behind the stock. Therefore, they focus more on fundamentals such as earnings, cash flows and dividends (if the company pays one).

As long as fundamentals are strong, they are confident that this strength will eventually be reflected in higher future stock values. Value investors care deeply about capital appreciation and total return. They are willing to wait patiently for that appreciation to happen as long as the fundamentals of the company they purchase remain solid and, in many cases, continue to grow. They expect outsized long-term returns resulting from purchasing a stock at a bargain valuation. While they may encounter poor short-term returns, their conviction and patience often rewards their efforts when they invest in an undervalued stock.

SOURCES

[1] Greenblatt, Joel. “The Little Book That Still Beats The Market”. 2005

[2] Mitchell, Cory. “Top Trader’s Magic Formula Investing Strategy”. Vantage Point Trading. April 3, 2017 <https://vantagepointtrading.com/-top-traders-magic-formula-investing-strategy/

[3] Lakonishok, Shliefer, and Vishny. “Contrarian Investments, Extrapolation, and Risk” NBER Working Paper. 1993 <http://www.nber.org/papers/w4360.pdf

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