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LEVEL

Value Investing – Understanding the Principles

Value investing may mean different things to different people. In simple words, it is the strategy of investing in stocks that trade at less than their intrinsic values. In other words, the goal of value investors is to determine companies that they believe are undervalued relative to the market or are trading at a discount to their intrinsic worth. A stock might trade at a discount to its intrinsic value due to reasons like a dent in the company's earnings or a one-off event that may have depressed the stock price. A value investor would look at it as a long-term investment opportunity.

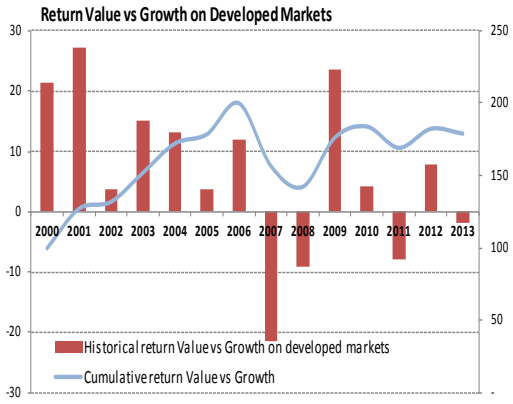
Estimating Intrinsic Value

Estimating the intrinsic value is one of the most important principles of value investing. However, the biggest problem with estimating the intrinsic value is that two investors with the same set of information can value a company differently.

For this reason, the value investor would always look for margin of safety. This simply means that the value investor would buy the stock at a big enough discount so as to allow some room for error in the estimation of the intrinsic value.

The key advantage of using margin of safety is that it minimises the chances of permanent loss of capital. Unlike speculative stocks whose price can plummet, it is less probable that value stocks will continue to experience price declines.

Benjamin Graham, considered as the father of value investing, only bought stocks when they were priced at two-third or less of their intrinsic value. This was the margin of safety which he felt was necessary to earn the best returns while minimizing the investment downside.



Efficient Market Hypothesis (EMH)

A value investor does not believe in the **efficient market hypothesis (EMH).** As per EMH, the current stock price already prices in all the information about the company. On the contrary, the value investor believes that stocks could be at times undervalued or overvalued. For example, the stock might be underpriced because of panic selling by investors during a downtrend in the economy (such as during the Great Recession in 1930s). Similarly, the stock might have become overvalued because of investors' excitement about the new technology which has not been proven yet (such as Dot com bubble in 1990s).

Herd Mentality

Herd mentality has been prevalent among stock market investors. However, value investors do not follow the herd. In fact, they have many characteristics of contrarians i.e. when everyone else is buying, they are often selling or standing back. Value investors usually do not buy the most popular stocks because they are mostly overpriced. They are cautious about investing in companies that are household names and take a second look at these stocks only when their stock prices have plummeted. Moreover, each value investor agrees on one thing that investors should buy business, not stocks. In other words, investors should look at the fundamentals of the company which have sound business and sound financials. They do not buy the stock but a percentage of ownership in a company.

Diligence and Patience

Value investing is a long-term strategy, as opposed to trading. It requires diligence and patience as it can sometimes takes years to get the pay-off from the strategy. However, the benefit is that long-term capital gains are taxed at a lower rate than the short-term capital gains.

Business Owner's Perspective

Approaching the stock valuation from a business owner's perspective is another important principle of value investing. The management can make a huge difference in the running of a company. A good management adds value while a bad management can destroy the most solid financials. The best managers ignore the market value of the company and focus on growing the business, thus creating long-term value for the shareholders. In the words of Warren Buffet, "look for three qualities: integrity, intelligence and energy. And if they don't have the first, the other two will kill you". A value investor can get a sense of the management's honesty by reading the company's previous years' financials which indicate how they delivered on their past promises. In addition, the size and reporting of the management's compensation gives a good idea about the company's corporate governance. The management which takes a reasonable fixed pay and depends on gains in the stock holding for the bonus is a good example. Also, at the very least, the company should expense its stock options.

Finding Undervalued Stocks

The following is the list of five must-have fundamental ratios for selecting a value portfolio.

Price-to-Earnings ratio (P/E) – It is one of the key fundamental ratios and is calculated by dividing the stock price by its earnings per share to come up with a value that indicates how much investors are willing to pay for each dollar of the company's earnings. A stock with lower P/E ratio costs less per share for the same level of financial performance than the one with higher P/E.

Price-to-Book ratio (P/B) – Like P/E ratio, the P/B ratio is another good indicator of what the investors are willing to pay for each dollar of the company's assets. The P/B ratio is calculated by dividing the stock price with book value of assets per share, less any intangibles like goodwill. By excluding intangibles, P/B ratio indicates what investors are paying for real-tangible assets.

Debt-to-Equity ratio (D/E) – This ratio indicates what percentage of the company's financing is received from debt and what percentage is from equity. A higher-than-industry D/E ratio is a warning sign.

Free Cash flow (FCF) – This is an important figure as it signifies how much actual cash the company is generating after capital investments. The company's net earnings might be negative but it might be generating significant free cash flow, which is a positive sign.

Price/Earnings to Growth ratio (PEG) – This ratio is calculated by dividing the P/E with annual EPS growth rate. In general, the P/E is higher for a company with higher growth rate. Thus, using only P/E ratio would make high-growth companies appear overvalued relative to others. By dividing the P/E ratio with earnings growth rate, the resultant ratio would be better for companies with different growth rates.

Though the above ratios are the key quantitative metrics, value investing is more of an art, and the above ratios have to be combined with common sense and critical thinking. A value investor needs to ask a series of questions to analyse the company's future prospects – can the company increase its revenues by raising prices? increasing sales? lowering expenses? or selling or closing unprofitable divisions? Who are the company's competitors and how strong they are? Is there some regulatory risks like government putting a cap on raising energy prices?

What is the Investing process?

There are two types of investing processes – top down and bottom up. A top down approach to investing begins with analysing the economy and the broad market conditions, interest rates and other macroeconomic data to decide which sector is expected to benefit. Then the stocks can be picked from these sectors. On the other hand, in the case of bottom up investing, the macroeconomic data and general market conditions are ignored. The focus is solely on stock selection based on the analysis of the company's business, balance sheet, valuation etc. **A value investor favours bottom up investing approach.**

Conclusion

To conclude, Value Investing demands a lot of discipline on part of the investors, but at the same time offers a large potential payoff.

A typical **value investing process** would take the following format:

•Establish minimum criteria for stock picks like P/B of <1.25x and/or ROE of >15%.

•Generate investment ideas through stock screening

•Perform detailed financial analysis of the company

•Evaluate the business growth prospects/potential upcoming themes

•Construct portfolio and monitor regularly.