FEATURE

// By Tobias Carlisle

HAS THE DEFINITION OF "VALUE INVESTING" CHANGED?

It's been a tough run for value investors. Depending on how it's measured, value has underperformed for about a decade.

The decade in the wilderness led many to abandon the strategy. Many others have drifted away from the strict implementation of it promoted by Benjamin Graham. They favor a modified version that embraces its spirit while ignoring some of its narrowest precepts. Does this mean the definition of "value investing" has changed?

Known as the *Dean of Wall Street* because he taught investing at Columbia while operating an investment practice, Graham authored the value investor's bibles *Security Analysis* (1934) and *The Intelligent Investor* (1949). He was also famously Warren Buffett's teacher. Graham promoted the idea of treating stocks as part ownership of businesses and ignoring price movements. Stocks could be bought only if they were undervalued on a conservative assessment of intrinsic value. He favored a valuation based on the liquidation value of a company—the dourest assessment of value—and a widely diversified portfolio. But Graham didn't invent value investing—he codified it.

There are many early examples of investors implementing what is clearly a value-type strategy. The great economist John Maynard Keynes is one such example. Buffett cited Keynes's philosophy approvingly in his 1991 *Berkshire Hathaway, Inc.* Chairman's Letter, quoting from a letter Keynes wrote to a business associate in 1934:[1]

1 Extracted from Concentrated Investing: Strategies of the World's Greatest Concentrated Value Investors (2016) https://amzn.to/3qApGq1

As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes.

Keynes was a contemporary of Graham's but favored a more concentrated approach that relied on the performance of the business, rather than the value of the assets. Buffett's evolution from a strict Grahamite investor to a Phil Fisher-influenced "franchise" investor, a strategy remarkably similar to the one Keynes finally adopted, is well documented.

Modern value investors typically style themselves on the strategy adopted by Buffett and Keynes. They have two criticisms of Graham's strategy. They point to the problems with book value as a proxy for intrinsic value. They also argue statistically cheap stocks—those on low multiples of assets or earnings—deserve to be cheap because they are bad businesses. Screening is so easy now that the market is picked over, they say. Only superior business analysis will lead to superior returns. And that means paying up for quality.

Many believe Graham was a captive of his time. He endured the Great Crash in 1929, so the argument goes, and was understandably conservative for the rest of his career. They may be surprised to learn that Graham also took a shot at old-fashioned book value in a 1932 Forbes article, writing, "It is undoubtedly true that the old-time investor laid too much stress upon book values and too little upon what the property could earn."[2] Book values have always been more favored by academics, who seek ease of calculation, than practitioners who seek returns.

In truth, the distinction between so-called Grahamite value investing and other forms of fundamental analysis has always been less about the precise metrics used to assess intrinsic value and more about the proper attitude to take when making the assessment. Graham has always emphasized a business-like approach to the appraisal, a margin of safety in the valuation, and the safety of principal. The second-order implications of that philosophy are conservatism in the valuation and financing of the business, and the defensibility of the business. None of that prevents a valuation based on robust growth when it's warranted. All it suggests is that valuations that depend on a rapid improvement in business prospects should be subject to intense scrutiny and skepticism.

For a short time between 2018 and 2020 the prevailing attitude in the market was that only the highest growth stocks were worth buying. Damn the losses, so the theory went, and buy. The business would turn on the cash-flow spigot once it won its niche. Just look at Amazon. It lost money all the way to online shopping dominance. Given the number of observations in the sample—one—you might have been forgiven for some hesitation in extrapolating the idea that all the money-losers were going to lose their way to Amazon-like dominance. The base rates, after all, said take the under. But who looks at base rates when there's money to be made? All we had to fear was the fear of missing out. And so, FOMO-ing at the mouth, investors paid 20, 30, 50 times sales for marginal businesses. Now, two years later many are chastened. They have rediscovered the reasons for Graham's conservatism.

The definition of value investing today is the same as it was in Graham's day. Buy the businesses that will earn the most on capital and pay as little as possible for them. The implementation is hard because it's hard to know what the future holds. Most businesses mean revert. Most earnings yields mean revert—sometimes the price goes up, sometimes the earnings go down. A portfolio of stocks that earn reasonable returns on investment bought at a price low enough to allow investors to participate in those returns will always do well given time.

Tobias Carlisle provides a list of these types of stocks for free on his website, acquirersmultiple.com. He also runs two ETFs that implement a deep value strategy, the mid and large cap Acquirers Fund (ZIG), and the small and micro Roundhill Acquirers Fund (DEEP)

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2 Graham, Benjamin, "Inflated Treasuries And Deflated Stockholders," Forbes Magazine, (1932). https://www.forbes.com/2008/10/23/inflated-treasuries-stockholders-cz_bg_1023forbesarchive.html?sh=b7b43d474647

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