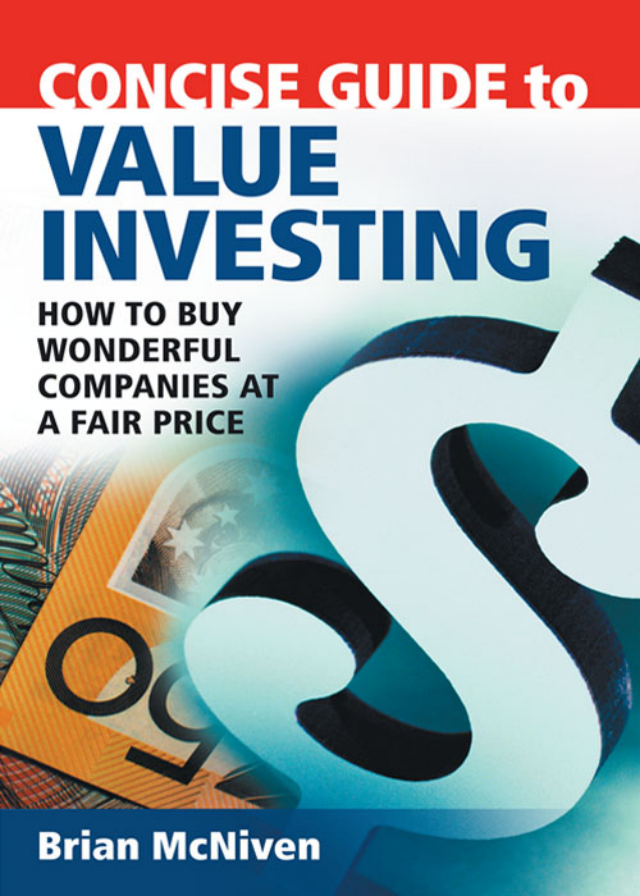


CONCISE GUIDE to VALUE INVESTING

**HOW TO BUY
WONDERFUL
COMPANIES AT
A FAIR PRICE**



Brian McNiven

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Preface

Although ‘margin of safety’ (being the difference between price and value) is said to be the most important consideration of the world’s greatest investors, Warren Buffett and his partner Charlie Munger, what good is it to be told that with no explanation of how value is calculated? It’s not surprising that Buffett himself remarked in 1985:

I have seen no trend toward value investing in the 35 years I’ve practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult.

I am more inclined to think that there is some perverse human characteristic that fails to see the connection between value investing and assessment of value. For instance: have you ever asked an investment adviser who recommends a stock on the

Preface

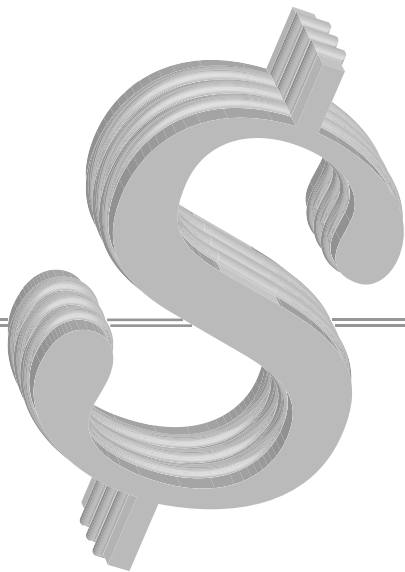
basis that it represents good value what *value* he or she places on the stock and what numerical assumptions he or she used in arriving at that value? In the investment world, no other word is so often used and so little understood.

In likening stock valuation to the problem of solving the St Petersburg Paradox, even the accredited securities analyst Benjamin Graham avoided tackling the issue, favouring the more simplistic approach of considering the relation between price and book value.

Although the objective of all investors is to seek superior returns with minimal risk by acquiring stocks in wonderful businesses at a price that represents good value, if they do not know how to calculate value, the objective is achieved by chance, rather than design.

This book will help you reduce your risks and maximise your rewards by providing you with a thorough understanding of value investing and how to determine the true value of a company.

Brian McNiven
Gold Coast
February 2008



Chapter 1

What is value investing?

If we acknowledge that investing is the intention to seek a required rate of return (RR) relative to risk based on an assessment of value, then all investing is 'value' investing. The deployment of capital in the absence of assessment of value is called speculation.

Although the art of speculation is covered by numerous books on stock trading and technical analysis, why is it necessary to use a tautology by including the word 'value' in the title of a book on investing? After all, would it not be equally foolish to refer to a car as an 'automobile car' or an ATM (automatic teller machine) as an 'ATM machine'?

That the market sees value investing as different from normal investing implies that the very factor on which

investing is based is little understood, and therefore nearly always ignored.

Value assessment does not rely on precision

Warren Buffett once said, 'I'd rather be approximately right than precisely wrong.' Stock valuation is subjective in that it requires a judgement of the sustainability of past profitability, and is therefore far from being an exact science. Like price, value will not increase in neat, even increments year after year, but will vary with the changing fortunes of the business.

The following commentary is typical of analysts who make buy/sell recommendations in the absence of quoting value and the business performance criteria on which they based their recommendation. One firm featured a leading article titled 'Be vaguely right, not precisely wrong'. The reason for this play on Buffett's words was to justify their recommendations not being accompanied by an indication of value. Their argument that value infers precision and is therefore misleading would seem to nullify their claim to be experts on value investing. If value investing is not about assessment of value, then what is it? Presumably, being 'vaguely right' means using some other means to vaguely determine whether a stock should be bought or sold at its current price. How such a vague notion can be used to generate precise recommendations was not mentioned.

An assessment of value is determined by making forward assumptions of a business's performance based on its historical performance. Depending on the current outlook for the business and its future prospects, the adopted performance criteria (APC) may differ from those that

What is value investing?

past performance indicates. One also needs to make an assessment of the RR to compensate for many factors, as discussed in chapter 6. The adopted assumptions are then used in the StockVal© formula to calculate the value, the preciseness of which is not as important as being, as Buffett suggests, ‘approximately right’. As essential as valuation is in determining the margin of safety between value and price, other factors need to be considered when deciding whether a stock should be bought or sold.

The argument that value is misleading because it infers precision is as foolish as suggesting that real-estate valuations are a waste of time because they too imply precision.

A recommendation may be correct, but unless it is accompanied by evidence of value, it can be considered only an unjustified expression of opinion. Warren Buffett says, ‘Wall Street is a place that people drive to in a Rolls Royce to get advice from people who ride to work on the subway’.

Eddie Cantor once said, ‘They told me to buy this stock for my old age and it worked perfectly. Within six months I felt like an old man’.

Investing in stocks is not about buying scrip that will go up and down in price, but about investing long term in a sound business that represents good value at its current price.

So-called ‘value’ and ‘growth’ stocks

One of the idiosyncrasies of stock market terminology is that it divides stocks into two separate categories: ‘value’ and ‘growth’. Growth stocks are considered to be those whose low dividend yields are compensated for by high earnings per share (EPS) growth, while value stocks are deemed to have the opposite characteristics.

Let's consider the foolishness of this notion. A company that distributes all profits as dividends and then replaces the distribution with new capital—either through its dividend reinvestment plan (DRP), placements or rights issues—would have the attributes of both value/yield and growth. Similarly, it would serve no purpose to call an interest-bearing deposit a 'yield/value deposit' and then change its designation to a 'growth deposit' when deciding to leave the interest to accumulate and compound.

Value stocks are considered to have one or more of the following attributes: above-average dividend yields, low price/earnings (P/E) ratios or low price-to-book value differentials. Not only do these attributes have nothing whatsoever to do with assessment of value, but stock selection based on them in the absence of value assessment is likely to ensure underperformance. Let's examine the reasons why by looking at table 1.1.

Table 1.1: choosing stocks by ratios

Year 1	Company A	Company B
Opening equity per share (\$)	10	10
Return on equity (ROE) (%)	10	20
EPS (\$)	1	2
P/E ratio	10	20
Price (\$)	10	40
Dividend yield (%)	10	0
Closing equity per share (\$)	10	12

What is value investing?

Year 2	Company A	Company B
Opening equity per share (\$)	10	12
ROE (%)	10	20
EPS (\$)	1	2.40
P/E ratio	10	20
Price (\$)	10	48
Dividend yield (%)	10	0
Closing equity per share (\$)	10	14.40
Investment return (%)	10	20

Company A, with its high dividend yield, would be referred to in market terminology as a value stock; while Company B with its EPS growth would be called a growth stock.

Assuming ROE and P/E ratios for both stocks remain constant, Company B, whose price increases by 20 per cent p.a., will produce double the return of Company A's 10 per cent annual dividend and static price. So even by paying four times equity per share, Company B represents better value at the given price.

It can also be seen that the other so-called value attributes of lower P/E ratio and zero price-to-book value differential of Company A are totally meaningless in terms of identifying value and, therefore, have nothing whatsoever to do with value or stock-selection criteria.

It should be noted that the actual pre-tax and post-tax returns will vary in accordance with the holding entity's

holding period, tax rate on capital gains, and what percentage of dividends are franked for tax-imputation credits. If the dividend yield of 10 per cent is fully franked, that is, paid out of a company's tax-paid profits, the recipient's pre-tax return, given a corporate tax rate of 30 per cent, would be 14.28 per cent. The valuation method to determine a fair price to pay for each stock using the StockVal© methodology, as discussed in chapter 6, allows for this factor by including grossed-up dividends in normalised earnings.

Let's consider a different scenario, presented in table 1.2.

Table 1.2: a different scenario

Year 1	Company C	Company D
Opening equity per share (\$)	10	10
ROE (%)	5	5
Profit per share (\$)	0.50	0.50
P/E ratio	10	10
Price (\$)	5	5
Dividend yield (%)	10	0
Closing equity per share (\$)	10	10.50
Year 2	Company C	Company D
Opening equity per share (\$)	10	10.50
ROE (%)	5	5
Profit per share (\$)	0.50	0.525
P/E ratio	10	10
Price (\$)	5	5.25
Dividend yield (%)	10	0
Closing equity per share (\$)	10	11.025

What is value investing?

Company C's decision to pay out all profits as dividends provides its shareholders with a respectable return of 10 per cent. By retaining profits to reinvest in the business at 5 per cent, the return to Company D's shareholders is limited to 5 per cent annual price growth.

It should be noted that the 5 per cent ROE (if representative of past performance) indicates that neither company is economically viable, and although the 10 per cent dividend yield from Company C looks attractive, the stock is best avoided at any price. Rather than suggesting that the price discount to book value is inviting, it simply indicates a dud business whose book value is likely to contain more air than substance.

EPS growth

EPS growth should be ignored as a determinant of stock selection. If two companies have an identical and constant increase in EPS of, say, 10 per cent, and one is reinvesting 100 per cent of profits and the other 50 per cent of profits, ROE will be 10 per cent and 20 per cent, respectively. In adopting a low RR of 10 per cent, the company with 10 per cent ROE and 10 per cent EPS growth is simply servicing the 10 per cent RR, so its value will be equal to its equity per share. The other company with the same EPS growth of 10 per cent and ROE of 20 per cent will be worth considerably more than its equity per share because it is also distributing 50 per cent of profits as dividends.

Furthermore, if our RR for the company with a ROE of 10 per cent is greater than 10 per cent, growth will have a negative impact on value, and the stock will be worth less than its equity per share.

Although these examples are intended to demonstrate that categorising stocks as either value or growth is meaningless, they also show the need to think in terms of the business performance and its implications on investment returns. This is the first step towards understanding value assessment.



Chapter 2

Dividend huggers

On the premise that retirees need cash-flow income, investment advisers usually steer them towards stocks with high dividend yields. For the reason given in the notes on table 1.2 in the previous chapter, reference to dividend yield to the exclusion of considering economic viability and value can prove costly.

Whether or not one needs cash-flow income, you should select stocks only on the basis of the price representing fair value after applying an RR to reflect the fundamentals of the business and the pricing of risk.

Contrary to conventional thinking, the cash flow to be derived from owning stocks does not depend on the limitation or surplus that dividends may provide. Investors

can decide how much cash-flow income they need, and pay themselves the appropriate dividend.

Let's consider how this can be achieved. Company B in table 1.1 looks as if it may be a good investment, but how can you procure cash flow from a business that doesn't pay dividends?

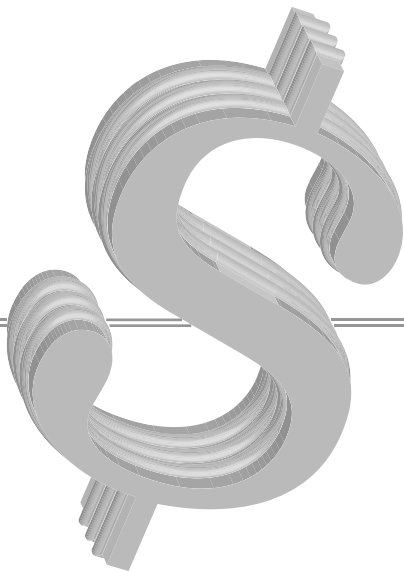
As a part owner of the business, you can use your stock in whatever way you wish. Let's say you bought 1000 shares for \$40 per share in Company B in table 1.1, and wanted to draw down a dividend of 10 per cent p.a. Given the assumptions in the table, after 12 months the total price has escalated to $\$48 \times 1000 \text{ shares} = \$48\,000$. You therefore need to sell 84 shares to draw down \$4032 (before costs) in cash. This leaves you with 916 shares priced at \$48, worth \$43 968 of remaining stock. In other words, you eat some of your cake while the remainder increases in size.

Had you purchased the high-dividend-yield stock in Company A, you would have received a \$4000 dividend but the cake would not have grown. Therefore, by comparison, the dividend equivalent from the nondividend-paying stock was not only free, but will increase annually as the residual price of unsold stock escalates. For instance: in year two, after paying yourself an increased dividend of \$4435 by selling 77 shares at \$57.60, the remaining parcel of 839 shares would be worth \$48 326. Note that in demonstrating this principle, the example assumes even incremental price increases without consideration of capital gains tax implications.

Those who are not averse to a conservative level of borrowing will achieve an even better result (provided the interest rate is less than annual price increases) by borrowing against the stock to generate the requisite cash flow. In addition to selling

stock not being required, the interest is tax deductible against other taxable income, while the escalating price ensures that the ratio of borrowings to equity decreases. However, it should be stressed that if your drawings plus interest are greater than the average long-term price escalation, the equation goes into reverse, and if sustained for any length of time, you may be required to sell stock to meet margin calls. Nearly all companies pay some dividends, so the borrowing exercise would merely provide a top-up. However, unless you really know what you are doing, you should avoid margin borrowing.

In fairness to dividend huggers and their advisers, if one cannot determine value, so long as the business is economically viable in terms of ROE and return on funds employed (ROFE), recourse to high-dividend stocks is the only option.



Chapter 3

Price and value

The business performance creates the value — the price creates the opportunity.

We are taught that value is defined as the price a willing but not anxious vendor is prepared to accept and a buyer is prepared to pay — a definition that applies to collectables, commodities and resources that are subject to variations in supply and demand. If manufacturers or retailers, for instance, are to remain in business, they must pay the going price for their requisite supplies or stock.

A stock index fund must also pay the going price for a stock to retain market weighting. In so doing, index funds have the unintended consequence of creating prices, rather than reflecting them — thus contributing to continuous

overpricing of highly capitalised stocks that comprise the bulk of market weighting. When a stock is included in an index, its price will increase by virtue of the need for index funds to buy the stock to maintain market weighting. Conversely, when it is removed from an index, its price will fall because the index funds must sell it. It was reported that the 15 companies that were dropped from the S&P 500 in 2002 lost an average of 73 per cent and were down 91 per cent from their highs.

Although stock prices are also governed by supply and demand, their value is not. Positive sentiment will increase demand (optimistic buyers) and reduce supply by limiting the number of willing sellers, while negative sentiment will have the opposite effect.

Although few would support the notion that the value of a financial security such as a stock is determined by the influence on prices of greed, fear, optimism and pessimism (market sentiment), reality implies the opposite.

At his breakfast meeting address to the Philanthropy Roundtable on 10 November 2000, Charlie Munger said:

It is an unfortunate fact that great and foolish excess can come into prices of common stocks in the aggregate. They are valued (priced) partly like bonds, based on roughly rational projections of value in producing future cash. But they are also valued (priced) partly like Rembrandt paintings, purchased mostly because their prices have gone up, so far. This situation, combined with big 'wealth effects', at first up and later down, can conceivably produce much mischief.

Let us try to investigate this by a 'thought experiment'. One of the big British pension funds once bought a lot of

ancient art, planning to sell it ten years later, which it did, at a modest profit. Suppose all pension funds purchased ancient art, and only ancient art with all their assets. Wouldn't we eventually have a terrible mess on our hands, with great and undesirable macroeconomic consequences? And wouldn't this mess be bad if only half of all pension funds were invested in ancient art? And if half of all stock value became a consequence of mania, isn't the situation much like the case wherein half of pension assets are in ancient art?

One thing we know with absolute certainty is that stock prices and their value can vary hugely. If price and value were synonymous, all stocks whose future business performance was in accordance with market expectations would produce similar long-term investment returns—a notion that is contemporaneously accepted as valid, although universally acknowledged in retrospect as false. Market commentators who fail to recognise this by referring to market prices as valuations, are by inference treating stocks as common commodities.

Although prices are deemed to reflect consensus, it should be remembered that prices are determined not by the majority of shareholders who are uninterested in buying or selling at the current temporary price, but by the tiny minority who are.

Following the adage that says it's impossible to be reasoned out of a belief that we were never reasoned into in the first place, if stocks are bought without reference to value, they will in turn be sold without reference to value.

Warren Buffett says:

What could be more exhilarating than to participate in a bull market in which the rewards to the owners of the

business become gloriously uncoupled from the plodding performance of the businesses themselves? Unfortunately, however, stocks can't outperform businesses indefinitely.

When prices increase at a greater rate than can be justified by business performance, they must eventually stagnate until the value catches up or they must retreat in the direction of the value. Only when a stock is bought at less than its value can price increases that exceed incremental increases in value be justified.

It is useful to understand some of the reasons for the disparity between price and value.

The efficient market hypothesis

Business students are taught that because all information on listed companies and the economy is instantly communicated to the investment community, prices immediately readjust to reflect the new information. This is referred to as the efficient market hypothesis (EMH). Business students are therefore led to believe that because no investor has an advantage over another, thinking is a waste of time. People such as Warren Buffett who have consistently outperformed the market to quite a remarkable degree for half a century are deemed to have been lucky, and are therefore a mere statistical aberration.

Investors should be buoyed by the knowledge that those who believe in the EMH have no understanding of why people such as Buffett and Munger succeed, and apparently have no interest in finding out. We should be mindful that while the brilliance of academia has achieved so much in terms of scientific and technological progress, nothing has been achieved in the advancement of reason since Socrates.