Value Investing:
Applying Graham and Buffett

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments
- For short term traders and technical analysis adherents:
  - This talk is about fundamentals and long term investing (usually 6 months to "forever")
  - I will not cover any topics of how to integrate TA or trading with value investing
- This talk covers the way I practice Value Investing, there are other ways to value invest that are not covered
  - Not exact Buffett and Graham but my adaptation

Value investing - buying something cheaper than for what it is worth

- Not very useful definition – this talk digs into it
- Different value investing approaches
  - "Buffettology“ – buying cheap earnings in great companies
  - "Net-nets", Graham – buying assets cheaply

Buffettology

- Buying stock is buying a business
  - Is it a good business?
  - Is it cheap?

- Is it good business?
  - High ROE
  - High margins
  - Moat

ROE – Return on Equity

- Equity = All assets – all liabilities
  - In simple cases: capital put into business
- ROE = Earnings/Equity
  - How much business returns on what you have put into it
  - Buy windmill for $10K, returns $1K in electricity production per year = 10% ROE
  - Most businesses more complicated

Good ROE: >15% for last 5-10 years

- Based on cost of capital
- Businesses with lower ROE may not be returning cost of capital to owners
- Examples:
    - NKE 19.80 21.50 22.10 21.20 24.10
    - GRMN 28.90 25.00 23.70 23.80 22.00 26.90 33.00 36.40
- Assumes low debt
    - Usually < 1 D/E or < 0.5 D/E
    - Zero debt is best - overcapitalized
    - Can use ROIC if there is debt
        - ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
- Cash flows vs. earnings

Net margins >10%

- High margins usually indicate some economic moat
  - Pharmaceuticals, branded goods
- >15% operating margin, >10% net margin
- Possible to buy low margin businesses which are category killers
  - Nike (7-10%), Walmart (3-4%), Cemex(4-8%), BNI (8-12%)

Company should have good moat

- Somewhat indicated by high long term ROE
- Somewhat indicated by high margins
- Subjective analysis
  - Have things changed?
  - Diworsefication – buying unrelated low margin businesses
  - Squeezing out returns without regard to risk – FNM, monoline insurers
  - Loss of patent protection – pharmas
  - New threats – newspapers
  - Value chain destruction – ratings agencies (Moody's)
  - Fads – Krispy Kreme, Crocs
  - New moat creation – railroads
- Areas of expertise and areas outside "circle of knowledge“

Is business cheap?

- Value business for its earnings
  - How much money would I make if this was my private company?
- How much money company will make in 10 years?
  - Assuming average ROE what will be the earnings in 10 years?
  - P/E in 10 years?
  - Rate of return?
- Example: NKE
  - Average ROE 20%
  - Earnings in 10 years = ROE*Equity*$(1+ROE)^9$ = $8B
  - Market cap = $8B x P/E (15) = $121B
  - Rate of return = ~13% after tax (calculations omitted)
- "Approximately right" calculation
  - Do not decide 13.6 vs 13.2% situations, decide 5% vs 15% situations
  - Discounted cash flow if needed

Caveats

- Very few companies are really "Buffettology" companies
  - Few examples in these slides may not be true "Buffettology companies" ☺
- Need careful scrutiny
- Usually cheap when something is going wrong – is this temporary?
  - New Coke, Amex disasters – temporary
  - FNM, FRE – gone
  - Moody's?
  - Think and discuss meticulously
- Usually large caps – followed by a lot of other people!
  - Are you right while others are wrong?

“Net nets” – Graham – Asset based investing

- Buying a dollar for half dollar
- Still looking at whole business but very different from Buffettology!
- Buy business, sell all assets = PROFIT!
  - Buy antique watch from pawnshop for $1, sell to collector for $1000
- Usually small cap
- Usually smelly dinky cigar butt companies
  - Can’t boast in a bar! ☺

Is this dollar selling for half-dollar?

- Best: below net cash value = cash + equivalents – all liabilities
- Very good: below net current assets =
  current assets – all liabilities
- Good?: below book or tangible assets =
  tangible assets – all liabilities

Analyzing assets

- Cash is king
  - Cash equivalents may not be so! Need to check
- Current assets
  - Inventory – how sellable it is?
  - Accounts receivable – will company receive them?
- Other assets
  - Plant, equipment – does it have any value at all?
  - Land, real estate – may be undervalued or overvalued
- Usually no need to analyze liabilities – they are all real

Analyzing assets examples

- GSIT 1/2008:
  - Current assets: 78M, liabilities 10M = 68M Net current asset value, 74M book value
  - Sold for 2.3-2.5 x 29M shares = 67-72M cap
- ACTS now:
  - Current assets: 284M, liabilities 20M = 264M Net current asset value, 286M book value
  - Sells for about 2.8, 240M market cap

Beyond assets of net-net

- Earnings of net-net
  - Profitability is preferable even if it is marginal
- Low debt
  - Like in Buffettology
  - High debt companies can go BK even with positive net assets
- Business outlook
  - Perennial net nets: distributors
- Examples
  - GSIT - profitable in Sep-Dec 2007, Jan-March 2008, no debt
  - ACTS – profitable, no debt

Safety in value investing

- Buffettology
  - Safety of great business
  - Moat ensures that company will continue to earn great return on capital
  - Future earnings returned to shareholders can ensure good return even if there was no stock market
- Net-nets
  - Safety of asset value
  - Company can go private, be acquired, etc.

When to sell value investment?

- Buffettology
  - Hold forever, pass to your kids and so on
    - KO
  - Hold till overvalued – expected return of future cash is too low
    - BNI, KO in 2000, MA
- Net-nets
  - Shorter term hold usually up to 2-3 years
    - If does not work out in that time, probably perennial net-net
  - Sell at 1.5-2x book
  - Takeovers, takeunders, etc.
  - Possibly short term capital gains, better in tax protected accounts

What to do when prices drop?

- For most value investments, prices drop after you buy them
- Buffettology
  - If fundamental business has not changed – add
  - If fundamental business has materially deteriorated – sell
  - In reality decision is difficult, since business usually changes negatively
    - AXP, MCO
- Net-nets
  - If balance sheet has not changed and business is not going to lose a lot of cash – add
  - If balance sheet has deteriorated and company is no longer a net-net OR business is going to lose a lot of cash – sell
- May be possible to use TA, stops, etc.

Value investing resources

- Value investors are cheap ☺
  - Don't buy subscriptions, don't buy charting tools, don't buy Value Line (well, maybe ☺), don't buy mansion, BMW, yacht, etc. ☺
- Company information
  - 10 year data: http://www.gurufocus.com/ - some errors!
  - 10 year data, graphs only for Quicken users: http://investing.quicken.com/research/evaluator.asp?symbol=nke
  - Recent financial statements: Yahoo Finance, Google Finance, SEC
- Ideas from other value investors
  - Buffett, Berkshire Hathaway news, SEC fillings, etc
  - Whitman, TAVFX letters to shareholders
  - Ariel Fund letters to shareholders
  - Blogs – just know which ones are value investors ☺
  - Value Investing Congress

Questions and Future Plans

- Interested in:

- More in depth income sheet or balance sheet analysis talk?
- Value investing meetings – analyze concrete companies, stocks, etc.
- Any other suggestions

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