The Value Investor’s Handbook

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Value investing, and any type of investing for that matter, varies in execution with each person. There are, however, some general principles that are shared by all value investors. These principles have been spelled out by famed investors like Peter Lynch, Kenneth Fisher, Warren Buffet, John Templeton and many others. In this article, we will look at these principles in the form of a value investor's handbook.

What is Value Investing?

Unlike some investment strategies, value investing is pretty simple. It doesn't require that you have an extensive background in finance (although understanding the basics will definitely help), sign up for an expensive subscription service or understand how to analyze squiggly lines on charts. If you have common sense, patience, money to invest and the willingness to do some reading and accounting, you can become a value investor. Here are a few fundamental concepts you'll need to understand before getting started.

The Concepts

Value Investing Fundamental No. 1: Companies Have Intrinsic Value

The basic concept behind value investing is so simple that you might already do it on a regular basis. The idea is that if you know the true value of something you can save a lot of money if you only buy things when they're on sale.

Most folks would agree that whether you buy a new TV when it's on sale or when it's at full price, you're getting the same TV with the same screen size and the same picture quality. The obvious assumption that we have to make is that the value of the TV will not depreciate with time as new technology becomes available. Stocks are the same way: the company's stock price can change even when the company's intrinsic value is the same. Stocks, like TVs, go through periods of higher and lower demand. These fluctuations change prices, but they don't change what you're getting.

Stocks work the same way. The only difference is that, unlike TVs, stocks will not be on sale at predictable times of year like Black Friday and their sale prices won't be advertised. If they were, stocks on sale would be less of a bargain because more people would know about the sale and drive the price up.

Value Investing Fundamental No. 2: Always Have a Margin of Safety

Buying stocks at bargain prices gives you a better chance at earning a profit later when you sell them. It also makes you less likely to lose money if the stock doesn't perform as you hope. This principle, called the margin of safety, is one of the keys to successful value investing. Unlike speculative stocks whose price can plummet, it is less probable that value stocks will continue to experience price declines. Benjamin Graham, the father of value investing, only bought stocks when they were priced at two-thirds or less of their intrinsic value. This was the margin of safety that he felt was necessary to earn the best returns while minimizing investment downside.

Value Investing Fundamental No. 3: The Efficient-Market Hypothesis Is Wrong

Value investors don't believe in the efficient-market hypothesis, which says that stock prices already take all information about a company into account. Value investors believe that sometimes stocks are underpriced or overpriced. For example, a stock might be underpriced because the economy is performing poorly and investors are panicking and selling all their stocks (think Great Recession). Or it might be overpriced because investors have gotten overly excited about a new technology that hasn't proven itself yet (think dot-com bubble).

Value Investing Fundamental No. 4: Successful Investors Don't Follow the Herd

Value investors possess many characteristics of contrarians – they don't follow the herd. Not only do they reject the efficient-market hypothesis, but when everyone else is buying, they're often selling or standing back. When everyone else is selling, they're buying or holding. Value investors don't buy the most popular stocks of the day (because they're typically overpriced), but they are willing to invest in companies that aren't household names if the financials check out. They also take a second look at stocks that are household names when those stocks' prices have plummeted. Value investors believe companies that offer consumers valuable products and services can recover from setbacks if their fundamentals remain strong.

Value investors only care about a stock's intrinsic value. They think about buying a stock for what it actually is – a percentage of ownership in a company. They want to own companies that they know have sound principles and sound financials, regardless of what everyone else is saying or doing.

Value Investing Fundamental No. 5: Investing Requires Diligence and Patience

Value investing is a long-term strategy – it does not provide instant gratification. You can't expect to buy a stock for Rs66 on Tuesday and sell it for Rs100 on Thursday. In fact, you may have to wait years before your stock investments pay off.

What's more, value investing is a bit of an art form – you can't simply use a value-investing formula to pick the right stocks which fit the desired criteria. Like all investment strategies, you must have the patience and diligence to stick with your investment philosophy even though you will occasionally lose money.

Managing the Risks in Value Investing

Although value investing properly executed is a low-to-medium-risk strategy, it still comes with the possibility of losing money. This section describes the key risks to be aware of and offers guidance on how to mitigate them.

Key Risks

- **Basing Your Calculations on the Wrong Numbers**

  Since value investing decisions are partly based on an analysis of financial statements, it is imperative that these calculations be performed correctly. Using the wrong numbers, performing the wrong calculation or making a mathematical typo can result in basing an investment decision on faulty information.

- **Overpaying**

  The biggest risk in value investing lies in overpaying for a stock. When you underpay for a stock, you reduce the amount of money you could lose if the stock performs poorly.

- **Not Diversifying**

Conventional investment wisdom says that investing in individual stocks can be a high-risk strategy. Instead, we are taught to invest in multiple stocks or stock indexes so that we have exposure to a wide variety of companies and economic sectors.

- **Listening to Your Emotions**

It is difficult to ignore your emotions when making investment decisions. Even if you can take a detached, critical standpoint when evaluating numbers, fear and excitement creep in when it comes time to actually use part of your hard-earned savings to purchase a stock. More importantly, once you have purchased the stock, you may be tempted to sell it if the price falls. You must remember that to be a value investor means to avoid the herd-mentality investment behaviors of buying when a stock's price is rising and selling when it is falling. Such behavior will destroy your returns.

- **Not Comparing Apples to Apples**

Comparing a company's stock to that of its competitors is one way value investors analyze their potential investments. However, companies differ in their accounting policies in ways that are perfectly legal. For an example, when you're comparing one company's P/E ratio to another's, you have to make sure that EPS has been calculated the same way for both companies.

- **Selling at the Wrong Time**

Even if you do everything right in terms of researching and purchasing your stocks, your entire strategy can fall apart if you sell at the wrong time. The wrong time to sell is when the market is suffering and stock prices are falling simply because investors are panicking, not because they are assessing the value of the quality of the underlying companies they have invested in. Another bad time to sell is when a stock's price falls because its earnings have fallen short of analysts' predictions.

The ideal time to sell your stock is when shares are overpriced relative to the company's intrinsic value. However, sometimes a significant change in the company or the industry that lowers the company's intrinsic value might also warrant a sale if you see losses on the horizon.

Next, we'll learn the names of some famous value investors and the strategies they've used to succeed.

Famous Value Investors

The interesting thing about the value investors who have been especially successful is that they have all achieved extraordinary returns while investing different amounts of money in different stocks at different times. While many of them worked or studied with each other at some point and their basic investment approaches are founded in the same principles, they have achieved their stellar results independently. Here are six value investors whose names you should know.

Benjamin Graham

All value investors trace their roots back to Benjamin Graham. Born in 1894, Graham is considered the father of value investing. He authored the two books that form the foundation of value investing theory: "Security Analysis"(with David Dodd) and "The Intelligent Investor." He developed the idea of buying stocks below their intrinsic value to limit downside risk and promoted the idea that stocks often trade at prices that do not reflect their intrinsic value.

Warren Buffett

Buffett was born in 1930. He was Graham's student at Columbia and later his employee. Buffett thinks of buying stocks as buying companies (and is wealthy enough that he sometimes buys entire companies), and he has an indefinite time horizon for his investments. He made his first investment at age 14 and became a millionaire by around age 30. He has become one of the wealthiest men in the world through value investing.

Seth Klarman

Klarman is the founder of the Baupost Group, which is an investment partnership, and has a history of double-digit returns and beating the S&P 500 since he founded it in 1983. He is risk-averse and bases his value stock picks on companies' liquidation value. He is also willing to think outside the box and choose investments other than U.S. stocks that other investors might not think to consider or might be afraid of. According to him, the keys to long-term investment success are to have "truly long-term capital; a flexible approach that enables you to move opportunistically across a broad array of markets, securities, and asset classes; deep industry knowledge; strong sourcing relationships; and a solid grounding in value investing principles." He also believes in looking at what other investors are doing to consider what you can do differently to outperform them.

Walter Schloss

In 1955, he started his own investment management firm. In 50 years as an investment manager, he averaged about 15% annual returns after fees. He uses company financial statements and the investment publication value line for much of his investment research. He looks for companies where management is a major stockholder, debt is low and the stock is trading at a discount to book value. Strategies he has used successfully include shorting stocks and holding large amounts of cash when he didn't see good investment opportunities. He also diversified beyond what some value investors would recommend, sometimes owning more than 100 stocks at a time. Schloss also never went to college, proving once again that you don't need a university degree to make lots of money and you don't need to major in finance to become a great investor.

Value Investing: Common Alternatives to Value Investing

There are dramatic differences in the ways different types of investors make their investment decisions. In this section, we'll look at some of the most common investment philosophies and see how each one compares to value investing.

Growth Investing

Unlike value investors, growth investors are not concerned with a stock's current price or with how that price relates to the stock's intrinsic value. It doesn't matter as much to them if a stock is a bit overvalued, as long as its price is rising and is expected to keep going up.

Income Investing

Like value investors, income investors are concerned with safety and principal preservation. However, income investors may look beyond stocks when seeking income-producing investments. Income investors and value investors both want to own the stocks of established, profitable companies; however, income investors make sure to acquire stocks that have a history of sharing their earnings with investors in the form of dividends.

Conclusion

Value investing is like buying Easter candy the day after Easter. The candy still has the same intrinsic value – it's still sugary, delicious and essentially as fresh as it was in the days leading up to Easter. But instead of paying full price to buy the candy the Saturday before Easter, when its demand is highest, value investors buy Easter candy the Monday after the holiday, when demand and prices plummet. They recognize that just because a piece of chocolate is shaped like a bunny doesn't make it any less delicious.

If you're already a bargain shopper, an independent thinker, a diligent worker and a patient person, you probably have what it takes to become a successful value investor. Value investors commonly do their own research and fundamental analysis, relying on financial statements and metrics such as profit margins, price-to-earnings ratios and book value to pick individual stocks to invest in. If this method doesn't appeal to you, however, you can pursue value investing through other means, if not try a different investment strategy altogether.