True Value

"Value investing" has had a rough go of it in recent years. In this quarter's commentary, we would like to share our thoughts about value investing and its future by answering a few questions:

1) What is "value investing"?
2) How has value performed?
3) When will it catch up?

In the 1992 Berkshire Hathaway annual letter, Warren Buffett offers a characteristically concise explanation of investment, speculation, and value investing. The letter's section on this topic is filled with so many terrific nuggets that we include it at the end of this commentary. Directly below are Warren's most salient points related to value investing.

- All investing is value investing.

  WB: "…we think the very term 'value investing' is redundant. What is 'investing' if it is not the act of seeking value at least sufficient to justify the amount paid?"

- Price speculation is the opposite of value investing.

  WB: "Consciously paying more for a stock than its calculated value - in the hope that it can soon be sold for a still-higher price - should be labeled speculation (which is neither illegal, immoral nor - in our view - financially fattening)."

- Value is defined as the net future cash flows produced by an asset.

  WB: "In The Theory of Investment Value, written over 50 years ago, John Burr Williams set forth the equation for value, which we condense here: *The value of any stock, bond or business today is determined by the cash inflows and outflows - discounted at an appropriate interest rate - that can be expected to occur during the remaining life of the asset*."

- The margin-of-safety principle – buying at a low price-to-value – defines the "Graham & Dodd" school of value investing.

  WB: "If we calculate the value of a common stock to be only slightly higher than its price, we're not interested in buying. We believe this margin-of-safety principle, so strongly emphasized by Ben Graham, to be the cornerstone of investment success."

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- Value investing is *not* defined by statistics such as low price-to-earnings or low price-to-book.

  WB: "Whether appropriate or not, the term 'value investing' is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth … "

- Growth is not distinct from value; it is a part of the value equation.

  WB: "…most analysts feel they must choose between two approaches customarily thought to be in opposition: 'value' and 'growth.' In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive."

Despite these simple principles for understanding the nature of investment, speculation, and value investing, little has changed since 1992. Index data providers populate value indexes based on low price-to-earnings and low price-to-book statistics, and the business press cites value indexes as representative of value investing.

Worse, most fund managers who identify themselves as value investors select their portfolios solely based on such statistics. Much like the rest of the industry, they also engage in "closet indexing", constructing portfolios to perform similarly to the index. It is worthwhile to pause and recall why such practices persist.

For one, many asset allocating gatekeepers still require fund managers to fit neatly into narrow "style boxes", adhering to a type of diversification which is in our opinion neither necessary nor useful. Additionally, there is job safety for fund managers who don't underperform their index by too much.

ACR avoids comparison with value indexes. We structure portfolios which can vary widely – higher and lower – from both broadly defined indexes such as the S&P 500 as well as indexes that track certain "value" ratios. Our sole objective is to buy quality securities with the biggest disparity between market price and intrinsic value.

Regardless of authenticity, anything "value" seems to have performed poorly in recent years – at least until methodology and time period are explored further. Below are charts which compare the performance of our flagship stock strategy EQR (Equity Quality Return), Berkshire Hathaway, the S&P 500, the S&P 500 Value Index, and S&P 500 Growth Index.

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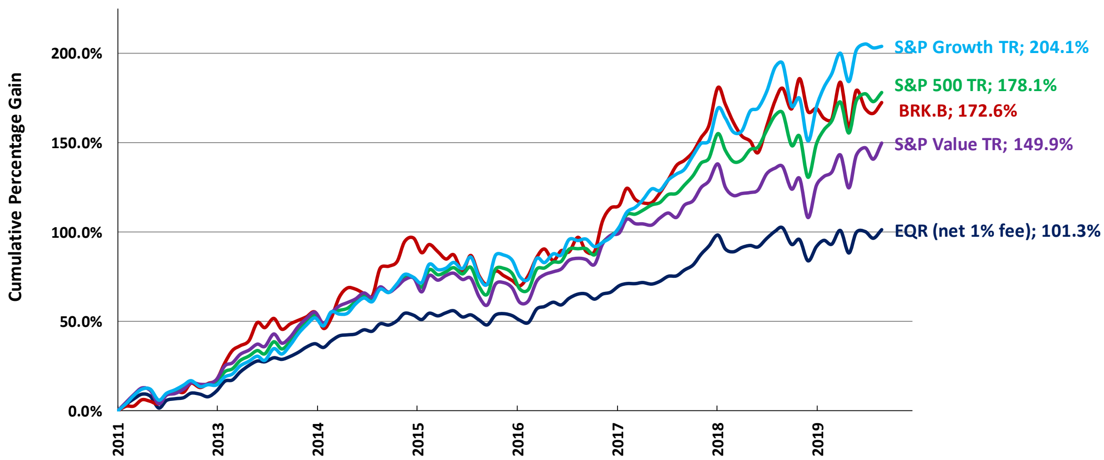
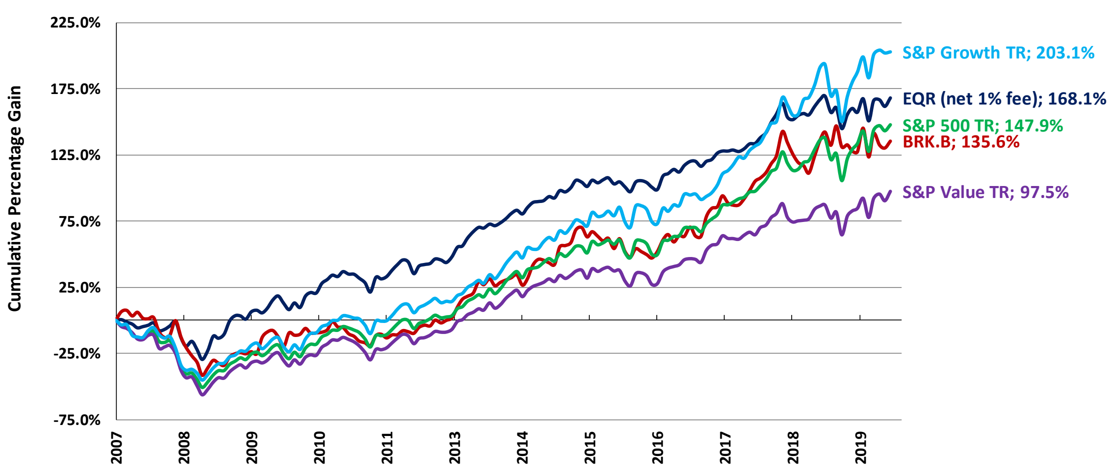
Cumulative Gains - January 2012 to September 2019



Measured since 2012, a time horizon long enough to be meaningful, yet not distorted by the lows of the financial crisis, all value approaches performed worse than "growth", with our EQR strategy pulling up the rear. This period is representative of a one-way market without any major setbacks.

Cumulative Gains - November 2007 to September 2019



However, when measured since 2007 to include a full economic cycle, things look a little different. The S&P 500 Value Index performed worst, yet the S&P 500 Growth Index still leads the pack. EQR moves to #2 with the S&P 500 and Berkshire Hathaway clustered in the middle. The S&P 500 Value Index performed abysmally during the financial crisis. Given this and growth's strong results in recent years, so-called value was left in the dust. Our view, of course, is that such distinctions are not useful. The S&P 500 Value Index is not true value. Results

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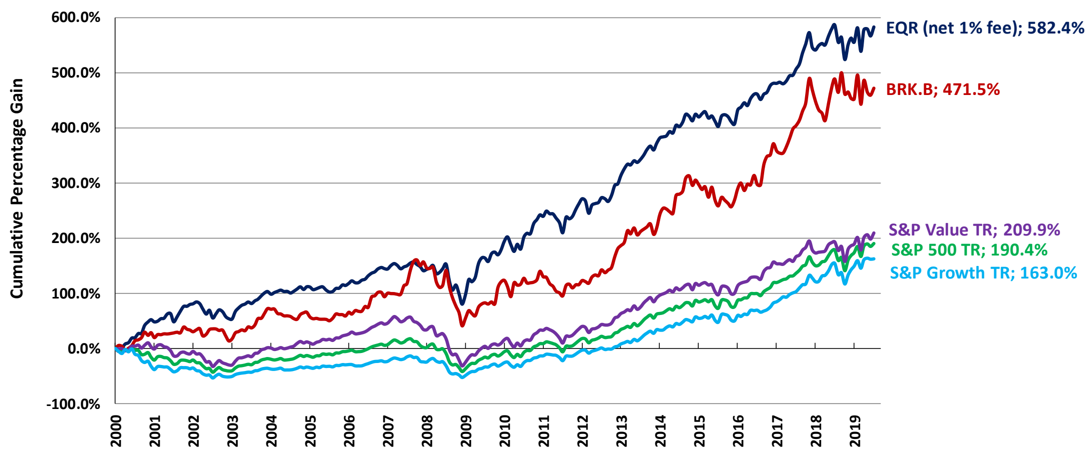
during a downturn, however, do matter. EQR and Berkshire Hathaway did reasonably well during this time, which considerably bolstered long-term results.

Cumulative Gains - April 2000 to September 2019



As shown in this last chart, cumulative gains since the market peak in 2000 look entirely different than the first two charts. EQR and Berkshire Hathaway pull away from the pack and "growth" shockingly falls into last place. The reason for such contrasting results between the first two charts and the third is simple: the first decade of the 21st century includes the inflation of one bubble and the deflation of two, whereas the second decade includes the inflation of one long bubble (defined here as an asset price which is highly likely to produce a return significantly lower than expected). This leads us to our last question: when will value catch up?

The third chart shows the question is moot in the long-term: true value does not need to "catch up" because it already leads by a long shot. The better question for ACR investors relates to the first chart: when will EQR catch up since 2012? The short answer is that we wish we knew, but we don't. Skilled value investors know "how much", not "when". Based on "how much", our previous two commentaries demonstrate our belief that the large valuation differences between EQR and the market today dwarf the amount by which EQR lagged in the short-term.

We are also confident in one broad, long-term forecast: the upcoming third decade of the 21st century is likely to look a lot more like the first decade than the second. Put another way, based on valuations shared in recent ACR commentaries, 2019 looks more like 1999 than any other time in the past twenty years. Therefore, we believe that EQR, Berkshire Hathaway and other true value investors will resume the extension of our large, long-term lead against the major indexes in the coming decade.

Nick Tompras
October 2019

As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

Excerpt from the Berkshire Hathaway 1992 Annual Letter

Our equity-investing strategy remains little changed from what it was fifteen years ago, when we said in the 1977 annual report: "We select our marketable equity securities in much the way we would evaluate a business for acquisition in its entirety. We want the business to be one (a) that we can understand; (b) with favorable long-term prospects; (c) operated by honest and competent people; and (d) available at a very attractive price." We have seen cause to make only one change in this creed: Because of both market conditions and our size, we now substitute "an attractive price" for "a very attractive price."

But how, you will ask, does one decide what's "attractive"? In answering this question, most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth." Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.

We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is *always* a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.

In addition, we think the very term "value investing" is redundant. What is “investing" if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value - in the hope that it can soon be sold for a still-higher price - should be labeled speculation (which is neither illegal, immoral nor - in our view - financially fattening).

Whether appropriate or not, the term "value investing" is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics - a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield - are in no way inconsistent with a "value" purchase.

Similarly, business growth, per se, tells us little about value. It's true that growth often has a positive impact on value, sometimes one of spectacular proportions. But such an effect is far from certain. For example, investors have regularly poured money into the domestic airline business to finance profitless (or worse) growth. For these investors, it would have been far better if Orville had failed to get off the ground at Kitty Hawk: The more the industry has grown, the worse the disaster for owners.

Growth benefits investors only when the business in point can invest at incremental returns that are enticing - in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value. In the case of a low-return business requiring incremental funds, growth hurts the investor.

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In The Theory of Investment Value, written over 50 years ago, John Burr Williams set forth the equation for value, which we condense here: *The value of any stock, bond or business today is determined by the cash inflows and outflows - discounted at an appropriate interest rate - that can be expected to occur during the remaining life of the asset.* Note that the formula is the same for stocks as for bonds. Even so, there is an important, and difficult to deal with, difference between the two: A bond has a coupon and maturity date that define future cash flows; but in the case of equities, the investment analyst must himself estimate the future "coupons." Furthermore, the quality of management affects the bond coupon only rarely - chiefly when management is so inept or dishonest that payment of interest is suspended. In contrast, the ability of management can dramatically affect the equity "coupons."

The investment shown by the discounted-flows-of-cash calculation to be the cheapest is the one that the investor should purchase - irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value. Moreover, though the value equation has usually shown equities to be cheaper than bonds, that result is not inevitable: When bonds are calculated to be the more attractive investment, they should be bought.

Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return. The worst business to own is one that must, or *will*, do the opposite - that is, consistently employ ever-greater amounts of capital at very low rates of return. Unfortunately, the first type of business is very hard to find: Most high-return businesses need relatively little capital. Shareholders of such a business usually will benefit if it pays out most of its earnings in dividends or makes significant stock repurchases.

Though the mathematical calculations required to evaluate equities are not difficult, an analyst - even one who is experienced and intelligent - can easily go wrong in estimating future "coupons." At Berkshire, we attempt to deal with this problem in two ways. First, we try to stick to businesses we believe we understand. That means they must be relatively simple and stable in character. If a business is complex or subject to constant change, we're not smart enough to predict future cash flows. Incidentally, that shortcoming doesn't bother us. What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know. An investor needs to do very few things right as long as he or she avoids big mistakes.

Second, and equally important, we insist on a margin of safety in our purchase price. If we calculate the value of a common stock to be only slightly higher than its price, we're not interested in buying. We believe this margin-of-safety principle, so strongly emphasized by Ben Graham, to be the cornerstone of investment success.

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The S&P 500 TR Index is a broad-based stock index including reinvestment of dividends and has been presented as an indication of domestic stock market performance. The S&P 500 TR index is unmanaged and cannot be purchased by investors.

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