

Getting Started in Value Investing

Author: Charles S. Mizrahi



Book Summary

Investing and making money in the stock markets can be confounding for many of us. While there are many investors who have made vast fortunes in the stock markets, there are many others that have literally lost the shirts on their back. There really is no standard trick or formula for making money in the stock markets. However, many investors who have stood the test of time and created great wealth in the markets, including the “Oracle of Omaha”, Warren Buffet, have been known to be proponents of value investing. Charles S. Mizrahi's, “Getting Started in Value Investing” is really a gem of a book that delivers what it promises. Simple and easy to understand, the book introduces the concept of value investing and clearly lays out the path that an average investor can take to build a robust long-term portfolio.

Key Takeaways

- Value investing is simple and requires an investor to follow some basic, common sense principles
- Company annual reports are a treasure trove of information. Investors must pour over a company's annual reports to understand the business and gauge where it is going
- When buying a stock, think that you are buying a part of the business
- Long term investors need not concern themselves with the short-term gyrations of the stock market
- Keep three words in mind – “Margin of Safety”
- Invest in quality businesses that have demonstrated consistent and predictable earnings
- While making investment decisions look at the quality of management, competitive advantage of the company, essential return metrics and finally buy it at the right price

Introducing Value Investing

There are two main approaches that an investor can adopt when making an investment decision. He can either follow the top down approach or he can follow the bottom up approach. In the top down approach, the investor needs to make a prediction about the future, then discern the impact of this on the investment and then make the trade. In this approach, there are a lot of unknown factors at play as it is difficult to predict the future with any amount of certainty. The bottom up approach, on the other hand, entails understanding a business and then estimating how the business will perform in the future. Generally, the bottom-up approach makes more sense than the top-down approach as it places more unknown factors within your control. There has been a lot of literature in finance to support value investing. Yet, there are not many investors that follow this style of investing. This can be partly attributed to some common misconceptions about value investing. These include:

1. Much of the information needed to research a stock is too costly, hard to get and difficult to understand - with the Securities Exchange Commission (SEC) making all sorts of disclosures mandatory, even the average investor has access to all the research that he would need to make an informed decision.
2. You can't beat the stock market – if you are the kind of investor who is looking for only short-term gains then you definitely cannot beat the stock markets. However, if you are the kind of investor who is looking to invest in quality businesses for a long period of time, then you definitely can beat the stock markets.

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3. Value investing is all about buying stocks at low prices – there is a vast difference between value and price. A stock trading at a low price might not have any value ie. growth prospects, while a stock trading at a high price might have significant value.
4. You have to be an accountant to understand a company's financial statements – all that you need to understand a company's financial statements is basic common sense and some guidance.
5. You can make more money investing in growth stocks than value stocks – there is not much difference between growth stocks and value stocks other than the fact that investors of growth stocks pay a high price for growth while investors of value stocks pay a lower price for the same growth.

One of the cornerstones of investment analysis is the Efficient Market Theory. It basically states that all the information about a company is already reflected in the stock price, which is why one cannot outperform the stock market. The theory postulates that all new information is immediately discounted by the smart money managers and thus the value of a company is immediately reflected in its price. One of the main reasons why this theory is flawed is that it assumes investors to be rational. However, this is not the case. The market is completely irrational and often overreacts. So, following the market is a big mistake. Additionally, there are various restrictions placed on institutional fund managers which handicap their performance and preclude them from buying certain stocks. These include:

1. Short-term time horizon
2. Marketcap limitations
3. Restriction on sector/geography/cash levels

Diversification is also not a solution for all your problems – it needs to be done judiciously. Most people today diversify their investments among a broad range of investments and market sectors, without taking the time to research and understand what they are investing in. Diversification works best on a small scale, best applied in the small realm of businesses you understand thoroughly. You don't need 30 to 40 different stocks; less than 10 is ideal and certainly not more than 20.

Invest in companies that are easy to understand, have a consistent and predictable operating history and know the companies that you should avoid. Do not treat investments like lottery tickets.

It is only logical that great companies should be the first place you focus on before making an investment. However, most investors do not follow this approach, citing the below mentioned reasons.

- Great companies are too efficiently priced
- Looking for the 10 bagger
- The financials get no respect

The trick is to find quality businesses, load up and hold them. Selecting a good investment is not the difficult

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part; sticking with it is what most people find challenging. Additionally, long-term investing also has significant tax advantages which add to the returns from that investment.

“Take Buffet's advice: Invest like you have a punch card with only 20 punches. You will then invest in only your best ideas. Stick to quality companies and hold them for the long term. The big money is made by sitting and not trading.”

Start with the Management

The first step towards understanding a business is getting up close and personal with its management. The management of a company should be focused on increasing shareholder value. Ask questions like; Is management rational? How do they allocate capital? Do they invest internally, return to shareholders, buy back shares or make acquisitions? Is the management transparent? Is the management sincere and truthful?

The best way to glean this information is by pouring over the Proxy Statement, the Management Discussion & Analysis in the annual report and the footnotes to accounts. The proxy statement is information provided by management to shareholders so that they can vote in an informed manner at annual shareholders' meetings. It also lists compensation paid to company executives. The proxy statement gives the investor a wealth of information on how the management is being compensated and what incentives are driving them. As an investor, you should spend time reading the annual report. Understand what the management is saying in the MD&A section of the annual report. Have they delivered on past promises? What is their tone of communication? What are their future projections about the industry and the business?

Competition: Threat or Opportunity – The Enduring Competitive Advantage

Trends determine not only what kinds of businesses dominate, but also how long they are likely to remain in business. A business that relies too much on a trend and is slow to innovate and adapt does not stay in business for too long. The average life span of a company in the S&P 500 index has gone from roughly 25 to 35 years in the 1950s to about 10 to 15 years today. This is telling in so many ways. While competition is ubiquitous, successful businesses are usually able to build and maintain a strong moat which helps them weather industry cycles as well as survive competition.

One of the criteria that Warren Buffet uses when buying a business is to analyse how big the company's competitive edge is. He called this “economic moat”. There are basically four types of moats that keep customers loyal. These include brand loyalty, ease of switching, cost considerations and protection. Competitive advantage is not forever. Hence, look for companies that can sustain their competitive advantage. Investing in businesses with an enduring competitive advantage is one of the cornerstones of successful value investing.

Read the Financial Statements

Financial statements help to test the financial health of a business and the business' future earnings ability. A company's financial statements are very well laid out in its annual report. The three reports that an investor needs to look at are:

1. Consolidated statement of income
2. Consolidated balance sheet
3. Consolidated statement of cash flows

Statement of Income

The income statement shows the company's earnings and expenses over a specific time period. While looking at an income statement the investor should make note of the company's sales growth. Investors can use a benchmark of five percent per year growth over the past three years as the minimum. Another number that investors should be cognisant of is the net profit margin (NPM). This is basically the net profit expressed as a percentage of sales and indicates how much of the sales was the company able to convert into profits. Net profit margin should be trending higher over the past five years and should be at or above the industry average, over the same time period. In addition to NPM, investors should also calculate earnings per share (EPS) and growth in EPS. A target of 10% increase in EPS should be used.

Balance Sheet

A balance sheet is a reflection of the assets and liabilities of a company as on a specific date. It provides investors with a snapshot of how much liquidity a company has to meet its obligations and how well they can handle their debt. Short term liquidity is measured by total current assets and total current liabilities. A good company should have at least \$1 of current assets for every \$1 of current liability. What this basically means is that the company should maintain a current ratio above 1. This should be consistent over a period of 3 to 5 years. In addition to short term liquidity, it is imperative that the company stays solvent over the long-term and has the ability to pay off interest and principal on their long-term debt. This can be gauged by calculating the debt to equity ratio.

Statement of Cash Flows

The statement of cash flows tells the investor the amount of cash that has been used up by the company and the amount of cash that is available. The cash that is available after operating, investing and financing activities is known as the free cash flow. Operating Activities measures the cash flow that went into and out of the company from day-to-day activities of the business. Investing Activities measures the cash flow generated from the purchase and sales of assets, investment in plants and equipment's and other line items. Financing Activities measures the amount of cash used to finance the company's cash flow: line of credit, issuance of

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debt at low rates to institutions to pay off company debt at higher rates etc.

When picking companies to invest in, stick to your circle of competence – stay within industries that are growing and have favourable economics. Pick leading companies in industries with better than average net profit margins, operating margins, and ROE. This tells you that the company is in a good industry and/or management must be doing something right.

The Price of a Stock versus the Value of the Company

Understand the difference between price and value. Many investors place too much emphasis on the price of a stock and not on the value they are getting.

Stock markets illogically gyrate from day to day which causes stock prices to frequently move up and down. Many times the stock markets become irrational because stocks are bought and sold by people who trade with their emotions rather than their minds. When buyers get very greedy or very fearful, they will buy or sell stocks at silly prices.

In a down market, with no apparent new or fundamental change taking place in the company, a long-term investor should welcome prices that bring down the valuation of the company and should accumulate more shares at that point. Lower prices are a good thing when you plan on holding for the long-term – it allows you to buy more for less. It all boils down to buying companies when they are selling below their underlying value.

The price of a stock is attractive only if it is less than its underlying value. Overpaying for even a great company can produce poor investment returns because it may take a very long time for the economics of the business to catch up with the high price you paid. Paying too high a price is the main reason investors lose patience with their investments and jump ship. When you buy stocks that are trading below their intrinsic value, you are taking out a large chunk of the downside, and time becomes your friend.

How to determine a fair price to pay for a stock?

There are basically three approaches one can take toward value investing:

1. Stock selling below reproduction cost of its current assets
2. Private transaction and formula valuation
3. Valuations based on future earnings

All this is complicated and not simple for an average investor. The worth of a business is found by estimating all the cash a company will earn over its lifetime and then discounting it back to present-day dollars. Look for companies that are able to grow their earnings in a consistent and predictable pattern for an extended period of time and are great businesses led by good management.

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The first step is to select companies that have demonstrated the ability to produce consistent and predictable earnings in the past and are in industries that are easily understandable. The next screen is to find companies that have a Value Line earnings predictability rating of 75 or greater. The third step is to focus on companies that have been able to produce an ROE of 15% or greater.

To Summarise

Do not adopt a myopic approach to investing. Stay focused on why you invested in the stock in the first place and be prepared to hold it for five or more years. Let the company's fundamentals tell you the real story of where the stock will go in the long term. Have the patience to stick with good companies when the waters are choppy.

Three common traits that all value investors share:

1. The way they think separates them from the crowd
2. They challenge the conventional wisdom
3. They avoid the latest investment trends

Intelligence, hard work, discipline and the above traits is what you need to become a successful investor. Value investing is just plain old common sense. Buy stocks in high-quality companies when they are trading below their underlying worth and then hold onto them. Over time if the business does well, the stock will follow.