Introduction to Value Investing

Definition of Value Investing: *"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."* - Benjamin Graham

Value investing is an investment approach that seeks to profit from identifying undervalued stocks. It is based on the idea that each stock has an intrinsic value, i.e. what it is truly worth. Through fundamental analysis of a company, we can determine what this intrinsic value is. The idea is to buy stocks that trade at a significant discount to their intrinsic values (i.e. they are cheaper than their true value). Once we buy an undervalued stock, the stock price eventually rises towards its intrinsic value, and makes a profit for us in the process. Value investing is conceptually simple, though requires effort to implement. Research process focuses on finding out the intrinsic value of a company. Primary tool for researching a company is called fundamental analysis.

Philosophy of Value Investing:

Benjamin Graham- the founder of Value Investing

4 components that define the philosophy behind value investing.

First component: Mr Market

Imagine you are in a partnership with Mr Market, where you can buy or sell shares. Each day, Mr. Market offers you prices for shares depending on his mood. If Mr Market is in a very optimistic mood, he will offer very high prices. In this case, an investor should cash out of shares. If Mr Market is in a very pessimistic mood, he will offer low prices, and this is the time to buy.

Second component: Intrinsic Value

Intrinsic value represents the true value of the company based on fundamentals. In the short term, market prices deviate from their intrinsic values due to changing market sentiments. In the long term, market prices return to intrinsic values. This process allows us to make profits, because we can buy stocks when they fall below their intrinsic values. We then hold them until they return to their intrinsic values in the long term.

Third component: Margin of Safety

Margin of safety is the difference between the current market price and the intrinsic value.

"A margin of safety is achieved when securities are purchased at prices sufficiently below underlying value to allow for human error, bad luck, or extreme volatility in a complex, unpredictable and rapidly changing world." - Seth Klarman

Fourth component: Investment Horizon

"In the short run, the market is a voting machine but in the long run it is a weighing machine." - Benjamin Graham

Value investing works in the long term, because that is when prices return to their intrinsic value. Value investing does not aim to predict what stock prices will do 2 days or 2 months from now. Instead, it aims to pick undervalued businesses that will outperform in the long term. This will eventually reflect in the stock price.

Evolution of Value Investing: Value investing started as a purely quantitative approach that has now evolved to incorporate a qualitative approach. Benjamin Graham's view was that one only needed to look at the financial statements of a company in order to determine its value. There was no need to analyze qualitative factors such as a company's management, future product offerings, etc. The numbers told the investor everything they needed to know about whether they should invest in a company or not. This approach is known as the cigar butt approach. The advantage of the quantitative approach is that it is based on hard facts alone. The analysis is objective, and less reliant on assumptions. Unfortunately, the quantitative approach does not account for all the factors that determine a company's true value. Qualitative factors such as the management quality, industry dynamics, competition, future products, consumer behavior, etc. are all relevant to a company's performance. Warren Buffet's approach incorporated these qualitative factors into his analysis, along with the quantitative factors.

Concept of 'Economic Moat'- A company's ability to maintain competitive advantages over its competitors to protect market share and long-term profitability. If a company has a high economic moat, it means it has an edge over its competitors. Warren Buffet's approach aims to identify companies with a high moat that are trading at reasonable prices. The moat is inherently a qualitative factor, and this represents the difference between Buffett's and Graham's approaches.

Coca-Cola Company - A classic Buffett stock

One of Buffett's most successful investments. Exemplifies the difference between the approaches of Graham and Buffett. Buffett admired the company due to the presence of a strong economic moat. He also analysed other factors like management quality, consumer behaviour, scalability of business, long term growth visibility, etc. He was able to conclude that Coca-Cola could earn much more 10 years from now than today. Graham on the other hand would have seen Coca-Cola as just another company. He would have analysed it based on existing earnings and ignore future growth potential. Graham was of the view that competition does not allow any company to earn extra profits for a prolonged period of time. Hence, he did not believe in paying any premium price. Buffett, however, focused on just those companies that could keep competition at bay for a prolonged period of time due to the presence of a strong economic moat. He was also willing to pay a slightly higher price for them.

Equitymaster's Approach: Here at Equitymaster, we closely follow Warren Buffett's approach to investing. We believe in identifying companies that have a high moat and sell for reasonable prices. Our investment philosophy can be summarized as follows:

"Don't try predicting where markets will go tomorrow or 6 months from now... Don't lose your calm over changing market sentiments... Buy stocks as if you are buying businesses... only the ones with solid long term fundamentals... only when they're selling cheap... And stay invested for the long term... Period"

We have 17 years of experience in the Indian stock markets. Over the years, we have built a tremendous track record for our stock recommendations. For large cap stocks, 8 out of 10 of our recommendations have been successful. For mid cap stocks, 7 out of 10 recommendations have been successful. The purpose of this course is to teach you our approach so that you can achieve similar levels of success with value investing.

When we use value investing, how much return are we looking for? In general, we use the following approach: For large cap stocks, we would buy a stock if the expected annual returns are 15% or higher. For a mid cap stock, we would buy a stock if the expected annual returns are 20% or higher. This is because mid caps are riskier.

We like to frame expected returns as the risk-free rate plus a premium. We must earn enough premium to justify taking risk. When we buy a stock, we also have a fairly long expecting holding period. For large cap and mid cap stocks, we expect to hold the stocks for around three years. For small cap stocks, we expect to hold the stocks for five years, due to the fact that small caps take longer to mature and deliver returns. Value investing is a long term approach, and patience is a key ingredient to success.

Warren Buffet's Four Filter Approach: Warren Buffet's four filter approach is a process by which we can arrive at an investment decision. It is like a checklist that we apply to any stock we are interested in. We identify companies that have:

1. **A business we understand**
   A business we understand is critical because we need to know what we are buying into.

   We stay away from companies that have overly complicated products and business models.

2. **Favorable long-term economics**
   Favorable long term economics means the company should have a competitive advantage (economic moat) that we believe is sustainable over the long term.

3. **Able and trustworthy management**
   Able and trustworthy management means that management consistently demonstrates competence and works in the interest of shareholders.

4. **A sensible price tag**
   Finally, a sensible price tag is nothing more than having a margin of safety.

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