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Value Investing 101

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Warren Buffett, Michael Price, Mario Gabelli, Walter Schloss, and Charles Royce are not the typical guest lecturers at a business school class. Then again, the Columbia University Graduate School of Business isn't just any business school, and professor Bruce Greenwald's class is anything but ordinary. Greenwald teaches the value investing course at Columbia and also authored *Value Investing: From Graham to Buffett and Beyond*. In part one of this five-part series, Greenwald shares with Fool contributor Matt Logan the three steps of value investing.

TMF: Perhaps one of the more controversial areas of value investing is the term itself. Some think of value investing as low price-to-book, low P/E, etc. Others think it's more **Berkshire Hathaway** (NYSE: BRK.A) (NYSE: BRK.B) Chairman Warren Buffett's approach. And then you have people, like Bill Miller at Legg Mason, who really stretch the term. What is value investing?

Greenwald: Value investing consists of three things -- three things that you have to do to be a good value investor. To some extent, they are all rooted in the way Ben Graham approached things.

The first thing is you have to understand the extent to which markets are efficient. It's just inescapable that whenever you sell a stock, somebody else is buying it; and whenever you buy a stock, somebody else is selling it. And one of you is wrong. Only in Lake Wobegon can more than 50% of the investors outperform the market. So there's an absolutely fundamental sense in which you've got to start off thinking that markets are efficient. You want to structure things so that you're on the right side of the trade, that the people on the other side of the trade are, in some sense, doing irrational things.

I think what Graham saw was that the best indicator of irrationality -- sort of a systematic, statistical indicator of irrationality on the other side -- is when things get oversold. And the way we talk about this in the course [the course he teaches at Columbia] is the search strategy. You look for cheap stocks, but you look for more than that. You look for obscure, because you don't want to be in a race with 60 analysts all looking at **Microsoft** (Nasdaq: MSFT). You want to be in a race where, ideally, you are the only one looking at the stock. The boring and ugly are good. Because I think Graham understood that psychologically, people just shied away from those stocks, and they, therefore, tended to get oversold.

Robert Heilbrunn, who actually endowed my chair, tells a story about that. He went to Ben Graham with all these high-rated bonds, and Ben Graham told him to sell them. Then he went to buy some deeply discounted bonds that were questionable. He went to his broker to buy them on Graham's advice. And his broker said, "We're not the kind of broker that buys bonds like that." And boy, that's the person you want on the other side of the trade -- is somebody with that kind of stupidity.

Ugly, traded-down, cheap, boring -- as opposed to glamorous, respectable, lottery-ticket type stocks, and prominent stocks -- are things that you want to be set up to look at as a value investor. So that's the first part of it. That's the search strategy. Unfortunately, in modern language, that's almost gotten to be the whole thing in a certain debased way. It is true that low market to book all over the world -- every place -- has outperformed the market in every extended period at least by 3% to 5%. So that gets you a long way. But I think to do better than that, as a real value investor, you have to not just look for cheap and take advantage of the historical statistics. You have to ask, "Where, within this universe even of cheap stocks, can I find trades that I'm going be on the right side of?" I think that's a question that modern value investors of whom I think the best of which are like Seth Klarman and Glen Greenberg -- even though he'll claim he's not a value investor -- they're always asking that question.

So that's the first step in value investing. It's to have a search strategy, so when you think you

locate a bargain and you have to ask yourself the question, "Why me God? Why has God made this bargain available only to me?" You can answer it terms of market mob psychology, or that you're the only one looking at it, or you have some sort of rationale for why this bargain has come to you. And that's the first thing. And, unfortunately, that in a debased form is what gets called "value investing."

The second thing you have to have is a good technology for valuing what you're buying. I don't know if you've read the book that Judd Kahn and I and other people wrote [*Value Investing: From Graham to Buffett and Beyond*].

TMF: Yes, I definitely did. It's a great book.

Greenwald: What you want to do is to have a technology that brings all the available information to bear, so you can cross-correlate the asset values with the earnings-power values, with your judgment about whether there's a franchise here. That if you're going to buy growth, you're absolutely certain that the franchise is there so the growth is going to be valuable. So the second thing -- you've located a promising stock -- and then, what a good value investor will have is a first-rate valuation technology.

The Graham technology is starting with the most reliable information, which is asset value, then looking at the second-most reliable information, which is current earnings -- with all the appropriate adjustments and getting an earnings-power value -- and then looking at those two and see what they tell you about the extent to which you are buying a franchise, which is value in excess of assets. And then, only then, looking at the growth. I think that's far superior than doing an undiscriminating cash flow analysis, where you can't really tell what the crucial assumptions are. So good value investors then bring a first-rate valuation discipline to the market. And that's the second part of it.

If you've got somebody who's only talking about growth prospects or short-term earnings prospects, you're going to be in trouble. And if you listen to Bill Miller, for example, he is very much an old-fashioned, low P/E guy. First of all, he doesn't buy tech stocks that are in fashion. He does tech stocks that are out of fashion. Secondly, he's pretty careful about valuation. I don't agree with his story about **Amazon** (Nasdaq: AMZN), but he is careful about taking out the amortization of the various stupid acquisitions that Amazon has done in the past and looking at the real profitability and real earnings power.

So if nothing else, this discipline of starting with what you know, which is the assets, then the earnings power, then the franchise -- whether it's there or not -- and then the growth; that whole sequence of things at least makes you look very carefully at what you're buying rather than getting caught up in the moment.

So you've got a decent search strategy. You've got a decent valuation strategy as a value investor. And the third thing you have to have is discipline and patience. In the story I'm going to tell you about discipline and patience and the value strategy is about Paul Sonkin -- his name is on the book -- who was put into business by a set of value investors, myself among others. He's just performed phenomenally. He's been in four and a half years, and you can't really tell on a four-and-a-half-year record, but his returns after fees have averaged about 25% with a market around 3.

TMF: That's incredible.

Greenwald: He has a strategy of very, very small stocks. So if he buys half a million dollars, then he has to file a 13D [required when you buy more than 5% of a company's stock] in some of these companies. But that means he's the only one there. So he satisfies the first criteria. He's got the basic valuation methodology. But one of the things we did in looking at his trades is that we looked at what he would have made if, when he made the first purchase of the stock -- the first time he bought it -- he just bought it there and he'd sold it at the first sales. So that he'd just done one buy decision and one sell decision, as opposed to buying it first, finding out, oops, the stock has continued to go down, but continuing to buy on the down side, having confidence in your valuation judgment. Of the 25% return, about 22% of it came from purchases at lower prices than the initial purchase. We've got Walter Schloss's archives, and it looks like -- we haven't got the numbers yet -- a large percentage of Walter Schloss's returns have come also over time from knowing that you're buying something worth buying. And then when it goes down, not getting frightened and dumping it, but continuing to buy. And then selling on the way up. Looks like that does a lot better than just averaging down.

TMF: I recently spoke with Mary Chris Gay, who is Bill Miller's colleague. That's their strategy, she said: Lowest average cost wins. I suppose that's confirmed now.

Greenwald: That's exactly right. But notice what that depends on. You have to have confidence in your valuation. And you have to have the discipline to stick with it, that if this is a good stock and nothing has changed about the underlying value of the company, then if it's a good stock at 8, then it's a better stock at 4, rather than people who will see a stock go from 8 to 4 and say, "Oh crap, something's going on here that I don't know about."

TMF: And there are a lot of people who think like that.

Greenwald: Who would think that and dump the stock. So the valuation rule is very important, which is part two of value investing. The discipline part of it is equally important. And it's important not only to persist when you see bargains, but also not to do stupid things. I think most value investors got in trouble to the extent they did -- and not a lot of them did -- in the boom because they just didn't have anything to do. There weren't bargains out there. And it's a big problem for them right at this moment. And they're tempted to do stupid things. So you have to have what I think of as a default strategy. When there's nothing active in value to buy, you have to think about what you want to do with your money. And it's not simply cash. You can do better than cash with various long-short strategies. If the market is really crazily overvalued, I think value investors have got to start to think about balancing things with appropriate short conditions. You have to have a well-articulated strategy of what you're going to do when you don't know what to do. And that's really the third part of value investing.

Now Warren Buffett has this wonderful example that he always quotes in which he says look, the nice thing about investing is that every day the pitcher throws you a ball and you don't have to swing. So you can wait for your pitch and then hit it out of the park. And that's the good news that is always true. But what he doesn't tell you is that for most money managers, they run up the score whether you swing or not. So you have to think about what you're going to do, if you're going to be disciplined in that context.

So I think of value investing as three things. A search strategy, which we talked about, which is where the low P/E, low market to book comes in. But it's not all of it, by any means, even of the search strategy. A valuation strategy. And a discipline approach to taking advantage of the information that your valuation is telling you about and having a default strategy when it's telling you it doesn't look like there's anything there.

Tomorrow: Bruce Greenwald explains what to do when bargains aren't to be found.

Read Matt Logan's complete interview with Bruce Greenwald:

- Value Investing 101
- To Hold Cash or Not?
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- Identifying Franchises
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Fool contributor Matt Logan owns shares in Berkshire Hathaway, but none of the other companies mentioned. The Motley Fool has a disclosure policy.

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