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What We Value

What exactly is "value investing" and why don't more people do it?

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A walk down any supermarket aisle makes it clear we live in a world of increasing product specialization. To break into a new market or grab more of an existing one, companies launch a dizzying array of new products in ever-more-specific categories. Want your soda with more caffeine or less? You've got it. More sugar? Less sugar? Six ounces, 10 ounces, 20 ounces? Whatever you like.

This trend has not been lost on marketers of investments. Specialized mutual funds and exchange-traded funds cover almost every imaginable combination of manager style, geographic reach, capitalization size and sector expertise. If you're looking for a mid-cap growth fund focused on the so-called BRIC countries (Brazil, Russia, India and China), you'll surely find it.

Dyed in the wool

We understand the marketing reality of specialization, but we'd argue that the most important factor in judging an investor's prospective gains or losses is the person's underlying philosophy. As you might guess from the name of this column, we're dyed-in-the-wool value investors, and we agree 100% with Berkshire Hathaway's vice-chairman, Charlie Munger, that "all sensible investing is value investing."

What does that mean? After all, value investors pursue a wide variety of strategies: Some invest primarily in small companies, while others like large ones. Some go mostly overseas while others stick to the U.S. Some run concentrated portfolios, and others don't. Some are activists; others aren't. But although specific strategies vary, the fundamental characteristics that unite value investors are many. We've come up with an even dozen:

1. We tend to buy what's out-of-favor rather than what's popular.

2. We focus on intrinsic company value -- what it's really worth -- and buy only when we're convinced we have a substantial margin of safety rather than try to guess where the herd will go next.

3. We understand and profit from reversion to the mean rather than project the immediate past indefinitely into the future.

4. We understand that beating the market requires a portfolio that looks quite different from the market, and we recognize that truly great investment ideas are rare. So we invest heavily in our handful of best ideas rather than hide behind the safety of closet indexing.

5. We focus on avoiding permanent losses and on absolute returns rather than on outperforming a benchmark and on relative returns.

6. We typically invest with a multiyear time horizon rather than focus on the month or quarter ahead.

7. We pride ourselves on conducting in-depth and proprietary analysis in search of what hedge-fund legend Michael Steinhardt calls "variant perceptions" rather than acting on tips or relying on Wall Street analysts.

8. We spend much of our time reading -- business publications, annual reports and the like -- rather than staring at the ticker or watching television shows about the market.

9. We spend time analyzing and understanding "micro" factors, such as a company's competitive advantages and growth prospects, instead of trying to predict the direction of interest rates, oil prices and the economy.

10. We cast a wide net, seeking mispriced securities across industries and across types and sizes of companies rather than accepting artificial style-box limitations on market capitalization and other criteria.

11. We make our own decisions and are willing to be held accountable for them rather than seek safety in whatever everyone else is buying or in decision-making by committee.

12. We admit our mistakes and seek to learn from them rather than take credit only for successes and attribute failures to bad luck.

If that all sounds perfectly sensible, you might wonder, as we sometimes do, why everyone isn't a value investor. A simple explanation is that you must be able to estimate the value of a business, which requires a great deal of skill and experience to do with reasonable accuracy. There are other explanations as well. James Montier, equity strategist at France's Société Générale, has studied the subject and finds the reasons are deeply rooted in human nature -- and, therefore, unlikely to ever change.

The first reason he cites is aversion to loss. Research shows that people perceive the pain of a loss about twice as strongly as the pleasure of a comparable gain. With its decidedly contrarian bent, value investing can sometimes fail to work for long periods of time, causing plenty of pain. To avoid such an outcome, investors get drawn into a sucker's game of rapidly trading their portfolios rather than waiting out the inevitable periods when they don't perform well.

A second reason investors don't embrace value investing is that it's a get-rich-slowly approach. We are all hard-wired to pursue actions that offer immediate gratification. But stocks that are cheap often offer the greatest long-term rewards precisely because they have no short-term catalyst.

A final reason for the dearth of value investors is the human desire to be part of the crowd. If you didn't own Internet stocks during the late 1990s, not only did you suffer lousy returns, but you also felt excluded. As Montier points out, "Contrarian strategies are the investment equivalent of seeking out social pain." That's not easy to do.

Value investors typically scour deeply out-of-favor sectors for opportunities, looking for the proverbial babies thrown out with the bath water. Last month, we wrote about two attractive opportunities, Target and Borders Group, in one of today's more reviled sectors -- retail. To that we'll add another: Barnes & Noble.

Although it's in the same business as Borders, as an investment **Barnes & Noble** (symbol BKS) has more in common with Target. Both are well-run, market-leading companies with strong balance sheets, trading at low multiples of earnings and buying back stock at a healthy rate.

You might ask why own a stock like this -- or any retailer -- given the environment we're in. Why not wait until the consumer outlook shows sure signs of getting better?

The simple answer is share price. At $30, Barnes & Noble has a market capitalization of $1.8 billion and -- after deducting year-end cash of $361 million -- an enterprise value (minus cash and plus debt) of $1.5 billion. Last year, Barnes & Noble had earnings before interest, taxes, depreciation and amortization (EBITDA) of $380 million and free cash flow (after all capital expenditures) of $238 million. Thus, the stock is trading at 3.8 times EBITDA on an enterprise-value basis and 6.1 times free cash flow, for a cash-flow yield (the return shareholders would get if all free cash flow were paid out as dividends) of 16.3%. When things start to get better, this current valuation will be long gone.

A private buyer would likely pay double those multiples for such a high-quality business -- especially one with a respected, conservative, entrepreneurial management team led by Len Riggio, who almost single-handedly invented the book-superstore business.

The biggest risk, of course, is continuing competitive pressure from big-box booksellers, such as Wal-Mart and Costco, and online alternatives, such as Amazon. But Barnes & Noble offers an in-store experience that's attractive and sufficiently distinct from competing options to give the company an excellent chance of growing at a low- to mid-single-digit rate for many years. Given today's share price, such growth would be icing on the cake and not at all necessary for B&N to turn out to be a successful investment.

Digging for insight

There's one more reason that value investors probably aren't at risk of being overrun by too many like-minded competitors: Value investing lacks drama. Poring over numbers and digging for deeper insight into a company or industry isn't exactly the adrenaline rush sought by the Jim Cramer, *Mad Money* crowd. To that, we'd suggest an alternative view of excitement: Sleeping well at night and compounding your money safely and at a decent clip over time seems like fun to us.

Columnists Whitney Tilson and John Heins co-edit ValueInvestor Insight *and* SuperInvestor Insight. *Mutual funds or hedge funds co-managed by Tilson own shares in Target, Borders and Barnes & Noble.*
