What Has Worked in Investing

THE RETIREMENT GROUP LLC

PARTNERS IN RETIREMENT

TABLE OF CONTENTS

1 Value vs. Growth

2 Value Investing

3 Intrinsic Value and Margin of Safety

4 Value Investing Historically

5 Discounted Stocks

8 Risk of Value Investing

10 Value Investing Strategy

11 How to Identify Stocks on Sale

13 Which of the Bargains are actually Bargains

14 Company Growth Stability

15 Metrics to Analyze

16 Common features of Value Stock

17 Conclusion

18 Sources

Value vs. Growth

In the investing world, there are two dominant strategies: value and growth. A typical growth strategy focuses on investing in companies with above-average gains in earnings and high profit growth in the future, and value investing focuses on finding quality companies priced at a discount in the market to its true intrinsic value. While the two are often viewed as opposite approaches, Warren Buffett puts it best that value and growth “are joined at the hip”[4]. The logic behind this is that growth is always a factor in the calculation of a company’s value. The return on investment and the consistency to generate growth all tie into a company’s valuation.

Value Investing

The principle behind value investing is very similar to the thought process that rational consumers go through when deciding what to buy. When going to the grocery store, most people will look through the weekly ad and see what is on sale to determine what and what not to buy. If steaks are on sale and chicken is not, you'll most likely end up purchasing the steaks because they're priced at a bargain to their usual price. The same logic follows for the rest of your groceries; you're going to weigh the options and choose the items that are the best quality for the cheapest price. Value investing is the exact same thing. It involves looking at what securities are priced at discounts compared to their true price and then picking the best companies of the bargains.

Intrinsic Value and Margin of Safety

The two main components of value investing are intrinsic value and margin of safety. Intrinsic value is what a corporate insider, with knowledge of all the financials and operations of the company, would value the company at. Determining this from an outsider perspective with only public information is the most difficult part of value investing, given that value investing doesn't take more intelligence than simple intuition and hard work, and so I believe it will be more helpful to show you the historical success of value investing before I get into the how to start doing so yourself. Margin of safety is the other key component of value investing and it is derived from purchasing stocks priced at a discount. Good companies that are already priced at deep discounts are unlikely to continue to decline in price and so they are said to have a margin of safety. The goal is that over time, the market will recognize the mispricing and the share price will eventually appreciate to its fair value, offering a nice return to investors at a lower risk.

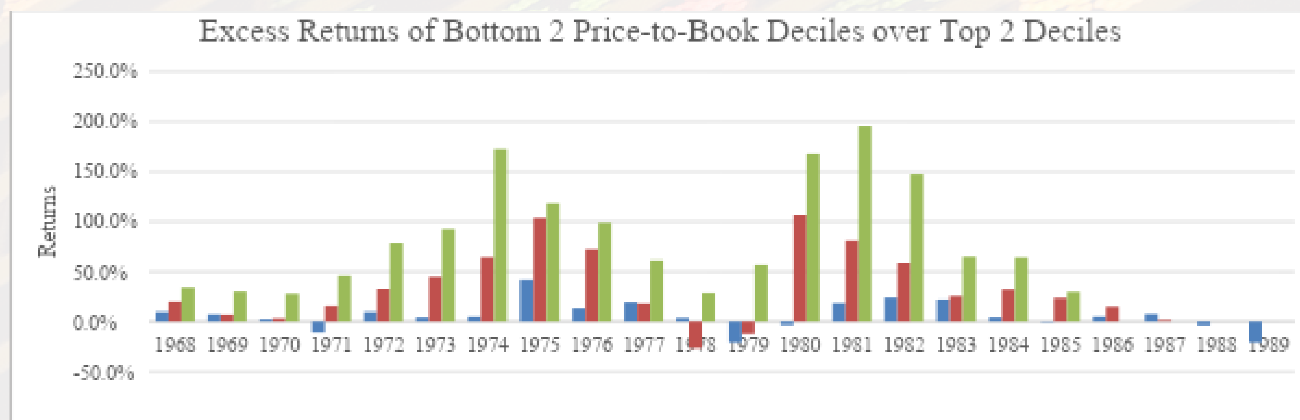
Value Investing Historically

All of this should make sense in theory, but the market is irrational at times and often driven by emotion rather than reason. The only true indicator of whether value investing consistently beats the market is to look at how it has performed historically. Even so, past performance is no guarantee of future results, but the principle behind value investing to buy things for less than they are worth is timeless.

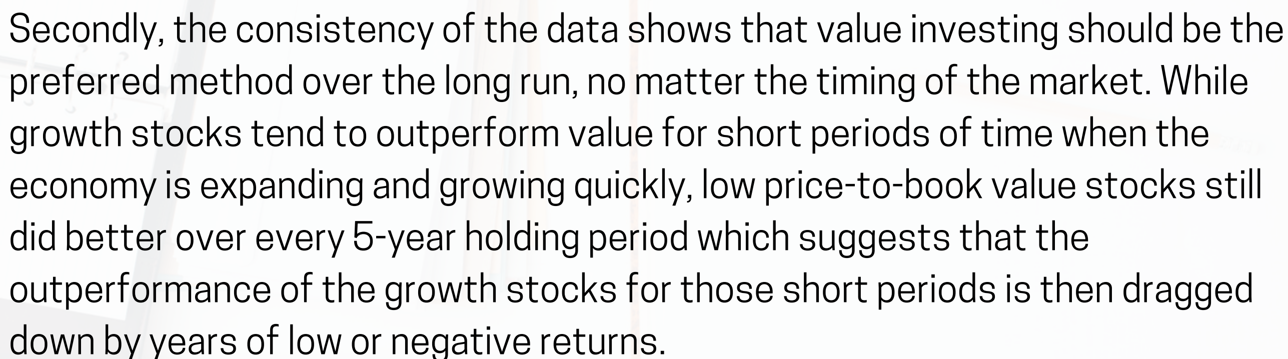
One of the oldest approaches to value investing is Benjamin Graham's net current asset criteria which says to purchase stocks that are priced at 66% or less of a company's assets minus liabilities and claims senior to a company's common stock (such as preferred stock). Graham reported that a diversified portfolio made up of net current asset stocks averaged a 20% return per year over a 30 year period. In the article "Ben Graham's Net Current Asset Values: A Performance Update", Henry Oppenheimer examined the performance of a net current asset portfolio from December 31, 1970 through December 31, 1983. Oppenheimer screened the entire S&P Security Owners List for stocks trading at 66% or below of net current assets and found 645 stocks that met this criteria over the 13 year period. The result was the net current asset portfolio had an average annual return of 29.4% compared to 11.5% for the NYSE-AMEX Index. Although the net current asset criteria clearly beat the market by a significant margin in this study, it's important to note that stocks trading at 66% of less of net current assets have become much less prevalent in today's market. And when stocks that meet the criteria are found, they are often micro-cap companies that have limited shares available to capitalize on. Even so, the results of this study still validate the success of purchasing securities that are priced at discounts to their intrinsic value.

Discounted Stocks

Investing in discounted stocks based on low price-to-book has also shown to be historically successful. Eugene L. Fama and Kenneth R. French ran regressions that examined the relationship between investment returns and different factors such as market beta, market cap, price/earnings ratio, and price-to-book value and found that price-to-book value "is consistently the most powerful for explaining the cross-section of average stock returns"[4]. To test this, Josef Lakonishok, Robert W. Vishny, and Andrei Shleifer ranked all stocks on the NYSE and AMEX according to price-to-book value.



As you can see from the graph above, the low price-to-book value deciles outperformed the high price-to-book value declines in almost every period. To be precise, the low price-to-book value deciles outperformed the high price-to-book value deciles in 16 out of the 22 years (73%), 18 out of the 20 3-year holding periods (90%), and in every single 5-year holding period[3]. This study shows a couple of things. First off, over the long run, as seen by the 5-year holding period returns, low price-to-book outperforms high price-to-book. Many growth stocks trade at high valuations such as high price-to-book value so this is another piece of evidence that supports the dominance of value investing over a growth strategy.



Secondly, the consistency of the data shows that value investing should be the preferred method over the long run, no matter the timing of the market. While growth stocks tend to outperform value for short periods of time when the economy is expanding and growing quickly, low price-to-book value stocks still did better over every 5-year holding period which suggests that the outperformance of the growth stocks for those short periods is then dragged down by years of low or negative returns.

Another criterion that Benjamin Graham used to find discounted stocks was based on low price-to-earnings, or a high earnings yield (the reciprocal of P/E). Graham's criteria said to purchase companies who earnings yield is at least twice the AAA bond yield and also the company's total debt is less than total book value. A high earnings yield indicates that the company's earnings are high in comparison to the price paid for the stock. Essentially, the higher the earnings yield, the more return you should expect per dollar and the better the value. Making sure that the company's total debt is less than book value is to ensure that the company can pay for its debt and isn't at risk of default. In order to observe the relationship between P/E and stock returns, Roger Ibbotson sorted companies into deciles according to P/E from December 31, 1966 through December 31, 1984 and calculated the compound annual return[2].

As expected, the companies with lower price-to-earnings, an indication of an undervalued stock, had higher compound annual returns than those with higher price-to-earnings. To give more context for these figures, the average return of all NYSE stocks during the same period returned 8.6% annually[2]. Beyond reinforcing the notion that investing in discounted stocks beats the market, this table gives a better representation of just how impactful a marginal increases in annual returns can be for the value of your holdings. If you had invested $1 million in the companies in the 5th decile, after the 19 year period, your holdings would be worth $5.32 million. With just a 1.09% increase in compounded annual return, $1 million invested in the 4th decile would have earned $6.43 million, over $1 million more from just a little over a 1% increase[2]!

Risks of Value Investing

Now that we've seen that value investing consistently earns higher returns than the market in the long run, is this due to higher risk? The tradeoff between risk and reward typically follows a direct relationship in which to earn a higher return, you must take on more risk. So in addition to testing the consistency of higher returns from low price-to-book value over high price-to-book value stocks, Lakonishok, Vishny, and Shleifer also examined the returns at different times in the market cycle. From 1968-1990, the returns of different price-to-book deciles were recorded during the best and worst 25 months of the stock market, the next 88 months where the stock market declined, and the other 122 months when the stock market gained[3].

Table 9: Average One-Month Investment Returns in Relation to Price as a Percentage of Book Value in the Worst and Best Stock Market Months, April 1968 – April 1990

	Price as a Percentage of Book Value Decile									
	(Highest Price as a Percentage of Book Value)					(Lowest Price as a Percentage of Book Value)				
	1	2	3	4	5	6	7	8	9	10
Worst 25 months in the stock market	(11.2%)	(11.0%)	(10.4%)	(10.0%)	(9.7%)	(9.1%)	(9.3%)	(9.2%)	(9.8%)	(10.2%)
Next worst 88 months in the stock market when the stock market declined	(2.9)	(2.8)	(2.6)	(2.5)	(2.3)	(2.0)	(2.1)	(2.0)	(1.8)	(2.2)
Best 25 months in the stock market	11.4	11.4	11.9	11.3	11.2	11.3	11.8	12.6	13.3	14.8
Next best 122 months in the stock market when the stock market increased	3.8	4.0	3.9	3.7	3.6	3.7	3.8	3.7	3.8	3.9

If this value investing strategy earned a higher return due to greater downside risk, then what we would notice is greater losses during the months where the stock market did poorly. But what we see from the data above is that on the contrary, the low price-to-book value deciles still outperform the high price-to-book value deciles in the worst months of the market. This goes back to margin of safety and how, intuitively, stocks priced at already low discounts to their intrinsic value are unlikely to decline significantly lower. If the market is declining, would you expect stocks that are overvalued or undervalued to suffer more? Logically, overvalued stocks can lose much more value until being considered undervalued so there is greater risk of huge losses. Thus, the higher returns from the low price-to-book value stocks actually come at less risk due to margin of safety.

Value Investing Strategies

An even easier investment strategy that has shown to work is to invest in companies where corporate insiders purchase a significant amount of shares in their own company. This may seem too obvious but that's exactly what value investing is. The table below shows 5 different studies that tracked the returns on stocks that had significant insider purchases[6].

Table 30: Investment Returns on Stocks Purchased after Insiders' Purchases

		Annualized Investment Return	
Study Author	Study Period	Insider Stocks	Market Index
Rogoff	1958	49.6%	29.7%
Glass	1961-1965	21.2	9.5
Devere	1960-1965	24.3	6.1
Jaffe	1962-1965	14.7	7.3
Zweig	1974-1976	45.8	15.3

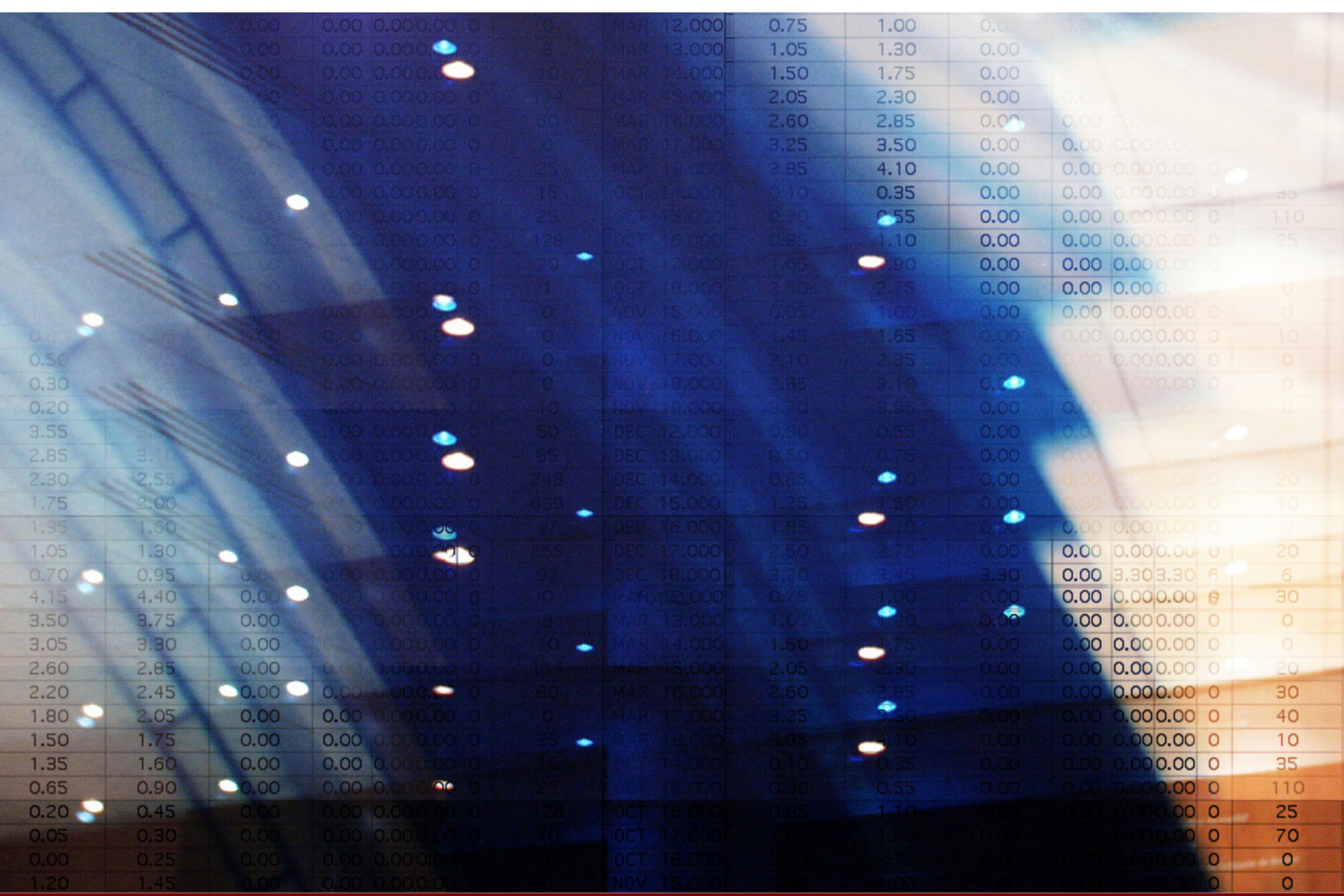
Clearly, the insider stocks had much higher annualized returns than the market index in each study. When a corporate insider purchases their own shares, this is usually a sign that the current stock price is depressed in relation to current value or that there is going to be some new information or product that will be coming out soon that is going to increase the value of the company. Insiders have a fuller picture of all the financials and some future decisions. With this information, they are able to more accurately calculate the intrinsic value of the company. Either way, the current stock price is viewed as a bargain that will soon increase in value. So essentially, this is another way of finding value stocks to invest in.

How to Identify Stocks on "Sale"?

Hopefully by now you're wondering how you can start identifying stocks that are on "sale" yourself and how to evaluate them to determine their intrinsic value. The first step is to narrow down the list from all stocks on the market to a few hundred or so stocks that are currently priced at a discount. Nowadays this is quite easy given the presence of many online screening services such as Zacks, Yahoo Finance, and Morningstar. Simply set your criteria for how you want to screen for discounted stocks such as by price-to-book or price-to-earnings and the screener will spit out all of the stocks that meet your requirements. From there, you can't just add all the stocks that meet your criteria to your portfolio because many of these stocks are priced at heavy discounts for good reason. The saying goes "don't try to catch a falling knife" and basically what this means is to avoid stocks that are plummeting for actual faults such as declining profits or poor financials. The stocks that we're looking to find are quality companies with strong financials that are just temporarily mispriced at a discount due to current investor sentiment.

Other ways to determine whether a stock is a bargain include looking at similar companies. One thing to look at is the valuation multiples in relation to others in the same industry, such as sales multiple or EBIT (earnings before interest and taxation) multiple. For example, if the average earnings multiple for a given industry is 10x earnings, and the company you're analyzing is currently valued at only 5x earnings, then this is an indicator that the stock is undervalued and would signal you to then look deeper into the company's financial statement to determine if the market valuation is correct or not.

Another way to determine whether a stock is trading at a discount is to look at recent mergers and acquisition prices that were paid for a comparable company to the one you're analyzing. Similar to how a realtor values a home by looking at what other houses in the neighborhood recently sold for, you can apply the same technique to valuing stocks. By comparing the market price of a company with a similar one that was recently acquired for a certain price, you can determine whether or not the market price is undervalued, fairly priced, or overvalued.



Which of the Bargains are actually Bargains?

So now that you know how to find stocks on sale, the next step is to determine which of the bargains are actually bargains and which are falling knives. One of the various ways to distinguish the two is to look at a company's financial statements to figure out if the company is well managed and how the company is growing. On the balance sheet, the main thing that you're looking to figure out is how liquid the company is. That is, how quickly can the company turn its assets into funds in order to pay off its short-term obligations. The way to investigate this is to look at current assets in relation to current liabilities. Current ratio and quick ratio are a couple of measures to look at, the only difference being that quick ratio doesn't count inventory towards current assets. They are calculated by dividing current assets over current liabilities so having a ratio over one is considered a liquid company. Debt-to-Equity ratio is another figure to consider because it shows how a company chooses to finance its operations. Having a high debt in relation to equity isn't necessarily a bad thing as long as the cash flows are sufficient to pay the interest and repayment but having too much debt going into a recessionary period where cash flows generally decline is something to be cautious about.

Company Growth Stability

Moving onto the income statement, the thing you're looking for now is if the company has been growing in profitability and is the growth stable. Stable growth is determined by comparing the annual income statements from the past 5+ years and seeing how revenues and earnings grew in comparison to expenses. The reason to look at annual statements is because there can be a lot of seasonality within the year for certain industries, such as the winter gear industry. A sign of good management is having consistent cash flows and the ability to grow so companies that have large fluctuations, for example, in revenue growth that goes from negative growth to high growth year to year is indicative of either mismanagement or high sensitivity to some market factor or costs. EBIT, which is earnings before interest and taxation, is commonly referred to for earnings in comparisons from company to company because the level of interest due on debt and taxes owed are specific to a company's choice of financing and its tax bracket.

Metrics to Analyze

Other metrics to look at are the return on assets, capital, and equity because the higher the return that a company is able to earn relative to how much it costs to make its product/service, the better and more efficient the company is at making profits. These measures of profitability each tell a slightly different story. All of them take net income or net earnings and then divide it by what they're trying to attribute the earnings to. Return on assets is calculated by taking net income/earnings over total worth of all assets. If we break the formula down, what it tells us is how much profit is generated per $1 of assets. So a ROA of 20% means that every $1 of assets produces 20 cents of profit (after expenses). Similarly, return on equity (ROE) measures how much earnings a company can generate from investor funding. There are a few way to calculate return on capital but I'm only going to focus on two. The first way to calculate the capital part of the formula is to add total debt with total equity because this is will give you the total capital or funding that is available to the company. So then when you divide net income or net earnings from this total capital, it'll indicate how effectively a company is using all of its funding.

Another way to calculate capital is to sum up working capital (current assets – current liabilities) and fixed assets. Working capital is a figure that tells us how much funding is used in day-to-day operations and inventory. Fixed assets include all the property, plant, and equipment needed to make the final product and so combined, working capital and fixed assets equal all of the physical capital that actually go towards making the product. This measure of return on capital, referred to as return on invested capital (ROIC), is very similar to ROA except it excludes intangible assets such as the copyrights, patents, and brand value. These intangible assets are hard to quantify and thus ROIC gives a better picture of how much earnings are produced as a result of just the physical capital needed to transform the product. So depending on what you're looking to find, you can choose whichever profitability metric is most relevant.

Common Features of Value Stock

- Bargain Price of company fundamentals: low pricing to book value, earning per share, cash flow per share, dividend and sales. More likely these stocks are undervalued.
- Small Market Capitalization
- Huge Recent Drop in price
- Insider purchase and company repurchase
- The methodology most academic paper uses to test value strategy is a stock sorting based on fundamentals and portfolio formation.
- It's possible to invest in publicly traded companies at prices which are significantly less than the underlying value of the companies' assets or business. However the excess return can only be captured in longer period of time with patience and perseverance.

Conclusion

This all may seem a bit complicated, but value investing is truly as simple as buying good companies at a bargain. This intuitive strategy has shown to consistently beat the market over the long run without exposing investors to any greater downside risk. Screening for discounted stocks is extremely easy today given the amount of free online screening tools that allow you to simply select certain characteristics such as low price-to-book and low price-to-earnings. When analyzing the financial statements, the terms and ratios may seem complex but they're quite simple once you break them down and realize what components go into the calculations and what they tell you. An easier option if you don't feel comfortable analyzing the financial statements or just don't have the time is to invest in a value fund. Read the different investment philosophies and choose whichever one makes the most logical sense to you. You've seen the substantial impact on the value of your holdings that just a 1% increase in annual returns can have after years of compounding so knowing how to invest wisely is an essential skill. If there's one thing that you should take away from all of this, it's that investing decisions are the same as any other purchasing decision: buy the best goods for the cheapest price.

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