VALUE INVESTING is the philosophy of investing in a security when its share price undervalues its intrinsic worth. Proponents of this philosophy include Warren Buffet, Charlie Munger, and the late Benjamin Graham.

Pros and Cons of Value Investing

Pros

- Reduces long-term risk of *losing money* by choosing investments which have a built in **margin of safety**
- "Hot" stock tips, hype, and mass hysteria do not affect the decisions a value investor makes
- Can produce steady, consistent gains that regularly outperform most benchmarks (e.g. S&P 500, DJIA, etc...)

Cons

- Value investing is extremely taxing to the average person, as significant analysis must be done prior to investing, and it requires an unusual level of confidence, as investments are made with an infinite time-horizon.
- Value Investors must be willing to remain within their *circle of competence* and invest only in businesses they fully understand. As you can probably see, value investing places great significance on being a savvy businessperson in addition to having an in-depth understanding of securities and markets.

Who are Value Investors?

The primary characteristic of a value investor is that he/she loves finding good deals. It might be best to think of them as shoppers who scour through the Sunday newspaper for coupons. This is exactly what they do, but instead of looking through the paper for good deals, they look through the universe of businesses. Value Investors are extremely unwilling to be part of the "herd" mentality, and so may often receive great criticism from market "pundits" for their investment decisions. A value investor is only willing to buy a company when it's down and out, **provided the price is right**. At any point in time, there are dozens of companies whose share prices are depressed. There are many reasons for this to happen, such as disappointing quarterly results, unexpected charges, changes in leadership, boring products, etc. A value investor will weigh the drop in price with the news that caused it. If it appears to the investor that the market overreacted (as it often does),then he or she might pick up some of the shares at a discount and wait it out.

What Investments do Value Investors Consider?

Value investing utilizes a strict methodology that is based on facts-driven reasoning, not hype. Never forget that the majority of investors lose money because they did not control their emotions.

In addition, a value investor does not look for companies who have yet to prove their products. A great example of this is the biotechnology industry. Many of the smaller biotechnology firms don't even make money at this stage, as they are still undergoing heavy research, development and clinical trials. Even fewer have patents that protect a consistent stream of revenue (as there usually isn't any revenue during R&D). A true value investor would never invest in a company that does not have an established competitive moat (e.g. brand name) protecting its core business.

Some of Warren Buffett's most successful investments were in companies that were financially struggling, but had enormous brand power, for example, COCA COLLA (COKE)

What Factors do Value Investors Use?

Value investors want to see that the company is making money and that the securities are cheap relative to the value of the company. There are many ways of determining this, but perhaps the most widely used introductory method is to look at the **earnings yield** of the company. This is the inverse of the **Price-to-Earnings Ratio**. The earnings yield can be interpreted as the earnings return on every dollar spent on this stock. Intuitively, stocks with low P/E ratios have high earnings yields, which may be indicative of a bargain (especially if the stock has been battered down by bad news, but nothing has changed fundamentally for the company or the industry). This isn't true in all situations, of course, and must not be used as the sole measure for evaluating a stock. The point is that value investors seek quantifiable facts to determine whether a security is undervalued or not.

However, most value investors agree that it is very difficult to determine the exact value of the company. Because of this uncertainty, value investors try to buy shares when the investment offers a reasonable *margin of safety*, which is the difference between the price and the calculated value. Historically, value investors have sought a margin of safety of around 60% - 75%. In slightly technical terms, this allows the investor a certain degree of confidence that the security is being offered at enough of a bargain that the risk of loss of principal is significantly lessened.

By using such quantifiable measurements, the value investor can safely stay away from making irrational security selections and being taken in by events like the dot-com busts (when prices were exorbitantly high when evaluated against the companies' fundamentals), and the recent credit crunch (which has essentially crippled global markets). How many times have you received a "hot tip" from someone who claims they know what they're talking about and assures you of great returns? **Value investors ignore "hot tips," hype, and market hysteria**.

As a word of caution - because of this somewhat contrarian approach, value investors sometime lose out on potential money makers. For example, most value investors stayed far away from tech stocks like Qualcomm, Google, and Apple. Had value investors bought in during the bust, their returns could have been enormous. However, compared against the risk of losing the investment, these companies offered no margin of safety.

Consider Warren Buffett's rules of investing:

1. **Don't lose money**
2. **Don't forget Rule #1**

Buffett's mentor and teacher was Benjamin Graham. Graham was the father of modern security analysis; a great investor in his own right, businessman (Chairman of the early Geico Corporation) and a Professor at Columbia University where Buffett was enrolled in graduate school majoring in Economics. Buffett gives full credit to Graham and says that he stands on the shoulders of Graham's early teachings on value investing.

However, Buffett refined his ideas and strategies and became more successful because he was influenced by the writings of Phillip Fisher and the influence of Charles Munger who became Buffett's Vice Chairman at Berkshire Hathaway. Fisher taught that an investor should examine investment ideas both quantitatively and qualitatively. That management was key in creating a profitable enterprise. From Munger, Buffett learned that it is better to buy great businesses at a fair price than a fair business at a great price.

Warren Buffett's most important contributions to the understanding of investing can be summed up as follows:

1) Concentrate your ideas within your circle of competence. Know what you are buying.

2) Buy only great businesses that have durable competitive advantages. Companies that can overcome macro-events.

3) Only invest with managers that think like owners. Substantial insider ownership is desirable.

4) Invest with a Margin of Safety. The three most important words in The field of Investing and (read Graham's book, "The Intelligent Investor") perhaps Graham's greatest legacy to investors.

Returns of Value Investing

Value Investing does not promise fantastic returns, or even market-beating returns. However, those who have practiced value investing consistently are considered by most to be among the greatest investors of this time; Warren Buffett, Peter Lynch, John Bogle, Mario Gabelli, Eddie Lampert, Charles Brandes, and quite a few others.

Another point - in the last 20 years, the S&P 500 has obtained annualized returns of 13% per year. Over the same period, small-capitalization companies (market caps are less than 2 billion dollars) that were considered value investments had annualized returns of 15%, better than all other types.

$1,000 invested in small-cap value investments 20 years ago, at an annual return of 15%, would yield about $16,366 today. $1,000 invested in the S&P 500 20 years ago, at an annual return of 13%, would yield about $11,523. As you can see, the value investments would return almost **$5,000** *more* (on a $1,000 investment)!