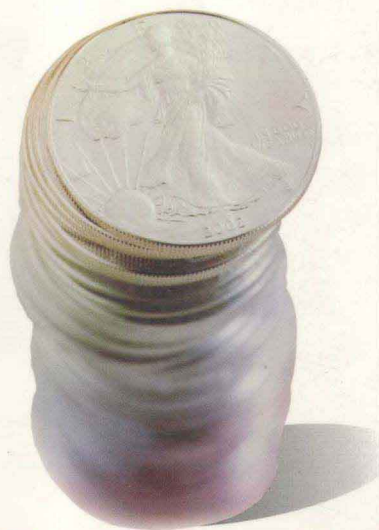


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Value Investing

FROM GRAHAM TO BUFFETT
AND BEYOND

Bruce C. N. Greenwald • Judd Kahn
Paul D. Sonkin • Michael van Biema

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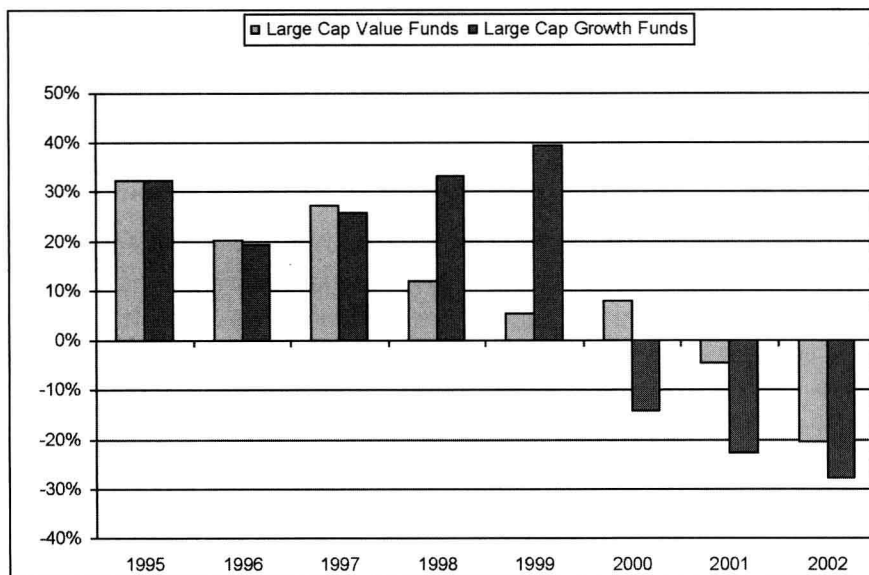
Preface to the Paperback Edition

THE VALUE OF VALUE INVESTING

We began to write the first edition of this book in February of 1999, almost 17 years into the longest bull market in American history. It was hard then to find an experienced value investor who did not think that share prices were unrealistically expensive. At that time, Alan Greenspan's "irrational exuberance" speech was over two years old. The major casualties of the exuberance had been a number of value-oriented money managers who lost their jobs because of poor relative performance. In the spring of 1999, *Institutional Investor* published a cover with the headline, "Value Investing: Can It Rise from the Ashes?" The *New York Times* was even more mordant, asking "What's Killing the Value Managers?" The answer was poor performance when compared to the growth-funds managers, who had beaten their value brethren by hefty margins in the past 12 months.

No tree, says one of the oldest chestnuts in the investment game, grows to the sky. Share prices peaked in the spring of 2000 and then began an unsteady, protracted, and severe decline. In the period between April of 2000 and the end of 2002, the S&P 500 Index, representing the largest U.S. companies, fell by more than 40 percent. The NASDAQ Composite, a more effervescent index that included most of the "new economy" companies that were supposed to lead the country into permanent prosperity, dropped by 70 percent. Even the staid Dow Jones Industrial Average, made

up of 30, mostly “old economy” firms, declined by more than 23 percent. In 2000, 2001, and 2002, the growth world of the 1990s had been turned upside down. Value investing moved ahead of growth. A dollar invested in a large cap growth fund at the start of 1995 was worth \$1.97 at the end of 2002. Invested in a large cap value fund, it would have been worth \$1.77. Value investors who stayed the course were rewarded, at least on a relative basis.



Source: Data from Morningstar

This reversal of fortune restored the historical relationship between the returns to value, as opposed to other investment approaches. In all extended periods prior to those five years beginning in 1995 and ending in the spring of 2000, value approaches outperformed the market as a whole and growth investing in particular. This superiority holds true for markets in the United States as well as the rest of the world. Like the demise of the bubble market, the long-term superiority of value investing is not an accident. The buzz words that formed the justification for valuations in the later 1990s—first-mover advantage, capturing eyeballs, secret sauce, digi-

tal DNA, and a new economy in which all old rules were irrelevant—make little sense when placed in the context of a competitive market economy. By contrast, the value investor's emphasis on real assets and current earnings, with prospects for profitable growth treated with skepticism, is rooted in an understanding of the dynamics of that economy.

Two examples of the value approach in action should make clear the disparity in valuation methods. The first example is general: How do we estimate the value of the Internet to new dot-com companies and to established firms? The new economy proponents stressed the potential impact of the Internet on productivity, talking about how much more work people could accomplish with the world virtually at their fingertips.

But productivity is not the same as profitability, and it is profits that ultimately determine stock prices. If all companies have equal access to the Internet—and they do, which is part of its appeal—then their productivity will improve together. Everyone's costs go down. In a competitive economy, that means prices will also decline. This is wonderful for consumers, but it does little for company profits. Only firms with unique abilities, companies that enjoy a competitive advantage in their use of the Internet, will reap extraordinary profits. The fact that buyers now have quick and cheap access to information, thanks to the Internet, only promotes additional competition over prices and features. Airline travelers, for instance, can search more easily for lower fares, more convenient routes, and more generous rewards. Intensified competition almost always lowers prices. The Internet can be both the friend of productivity and the scourge of profitability. Value investors, who understood the economics of heightened competition, avoided the Internet mania.

The second example of the value approach is specific. Enron was a poster child of the era, riding the mania until it exploded. Its executives published bad financial information; some was misleading, and some was simply false. But even these doctored reports, designed to make the company's performance look good, portrayed a company with no better than average results. In 2001, before its collapse, Enron's return on capital was 6 percent, and its return on equity was only 11 percent. Despite these mediocre figures, investors seemed to have been blinded by the kind of faith that the Apostle Paul described in his letter to the Hebrews as "the

substance of things hoped for, the evidence of things not seen.” The hope seems to have been that Enron would monopolize certain novel markets that trade sophisticated financial instruments and new economy commodities, such as bandwidth. But we ought to know too much about markets of this sort to have faith that they can be monopolized. The Hunt brothers proved that point when they tried to corner the silver market in the early 1980s, at great cost to themselves. Firms such as Goldman Sachs, with earnings far superior to Enron’s, trade at relatively low multiples, another sign that there are no monopolies here to be milked. Value investors did not buy into the Enron dream, even before its malfeasance was exposed.

This book is dedicated to the creation of more value investors. Beyond the superior returns that a value approach has earned over time, a value investor’s discipline, widely applied, should help to inoculate both the financial markets and the wider economy from the baleful effects of bubble market absurdities. In retrospect, the effects of a bubble on the markets are obvious. On the way up, investors become too confident about their anticipated returns. Money floods in—part of the definition of a bubble—and prices rise to even more unrealistic levels. At some point, air starts to come out of the bubble. Share prices drop and some investors, including pension plans and other institutional holders, lose a lot of money. Many equity investors feel burned and move out of the stock market for good, and it takes years for new ones to take their place. The consequence of a bubble for markets, then, is to reward winners and punish losers with a savage intensity.

The influence of a bubble market on the broader economy may be even more long lasting and more perverse. Here are some of the more important consequences of this last bubble:

- Excessive investment in telecommunications and related industries, thanks to the funds available from stock offerings and borrowings that the bubble market made possible. The result has been an overhang of capacity and equipment that depresses the earnings of those firms that have survived.

- Expansion to the point of collapse, or near-collapse, by companies that were profitable but used the high price of their shares to make foolish acquisitions or increase capacity beyond what a sensible view of the future would have allowed. The bankruptcies of Enron, Global Crossing, Adelphia, MCI WorldCom, and the others were a blow, but the decline in the market capitalization of Lucent, Cisco, Corning, Nortel, AOL-Time Warner, and other survivors took a larger bite out of people's portfolios. Some of these firms are so impaired that their future may be in jeopardy.
- Incompetent, dishonest, and fraudulent behavior by corporate executives, boards of directors, auditors, investment bankers, security analysts, and other market participants. They exaggerated revenues, embellished earnings, and concealed debt, all to make the company's financial performance look better than it was. The payoffs for the executives were higher share prices that allowed them to turn their stock options into gold. For the auditors and financial firms doing business with these companies, the payoffs were lucrative consulting contracts and underwriting fees. The exposure of this chicanery left large parts of the investing public without faith in the honesty and fairness of financial markets and with less inclination to participate in the future. The guardians failed to do their jobs. The bubble market made many forget about the riskiness of the stock market, and the collapse of the bubble made many exaggerate it, helping to delay recovery.

Competitive market economies have always been subject to business cycles. One of the nostrums peddled by proponents of the new economy was that things would be different this time. Modern information technology would give firms the ability to control their inventories, adjust their risk exposures, and otherwise avoid the excesses responsible for previous cycles. It turned out that the new economy story and the runaway market it helped to foster were themselves the excesses. Like all cycles, they are painful on the way down. A wider acceptance of the principles of value investing may ease some of that pain the next time the mania sets in.

Preface to the First Edition

Benjamin Graham is commonly credited with establishing security analysis as a reasonably firm discipline within an investment world that had been dominated by speculation, insider information, and other practices at best unsound and at worst downright shady. The publication of *Security Analysis* with David Dodd in 1934 marks the start of a profession. Graham made his ideas and techniques more available to professionals and interested amateurs with *The Intelligent Investor*, which initially appeared in 1949. Each book has been revised several times. *Security Analysis* is available both in its initial, classic version and in a fifth edition that purists feel has little of Graham remaining. The New York Society of Security Analysts, an association Graham founded, contends that he “is to investing what Euclid is to geometry, and Darwin is to the study of evolution.” Though this may carry the praise further than Graham himself would have allowed, his significance to investing is not in dispute.

Graham did more than put investing on a rational foundation. He also engraved on the minds of his students and devotees a strong preference for what would now be called *value investing*. To present the most succinct description, the value investor seeks to purchase a security at a bargain price, the proverbial dollar for 50 cents. There is considerably more to it than that, as this book attests. Still, despite all the changes in the investment world since the 1920s, Graham initiated an approach to investing that remains vital today. Our effort here is to build on his work and on that of his

successors and to incorporate the advances in value investing that have appeared over the last three or four decades.

Starting in 1928, Graham began to teach a course on security analysis at Columbia University, his alma mater. The book he wrote with Dodd grew from that course. The course at Columbia lasted through several incarnations after Graham and Dodd and passed eventually into the hands of Roger Murray, an author of the fifth edition of *Security Analysis*. On Murray's retirement in 1978, the course and the tradition disappeared from the formal academic curriculum. Outside the university, the intellectual life of value investing remained robust in the world of practicing investors, thanks primarily to Warren Buffett, who had taken the original Graham and Dodd course in 1950 after having been exposed to *The Intelligent Investor*. He read the first edition of *Security Analysis* while on his honeymoon. Together with a number of other Graham students, Walter Schloss among them, Buffett established records of consistent investment success that attracted continuing attention to value investing.

Further generations of former students, including Mario Gabelli, who had taken the course with Roger Murray, continued to refine and extend the basic value approach. In 1992 Gabelli prevailed on Murray to offer a series of lectures on value investing to Gabelli's own analysts, who had found nothing like it in their formal MBA courses. As the newly appointed Heilbrunn Professor of Asset Management and Finance, I attended those lectures out of curiosity. Like generations of investors who preceded me, I was struck by the compelling logic of Graham's approach. As a consequence, in 1993 I dragooned Roger Murray into joining me in offering a revived and revised version of the value course. That course, which continues to attract large numbers of both MBA and professional-level students, is the point of departure for this book.

Meanwhile, in the 1950s and 1960s a new approach to investment analysis emerged from scholars who had been trained in economics or statistics. As a group they produced a body of work, sometimes called *modern investment theory*, that, if accurate, has several inescapable implications for investors:

- The market is efficient, and it is not possible to outdo its returns except by accident.

- Risk is measured by the contribution of individual securities to the volatility of returns of widely diversified portfolios, rather than the more common-sense understanding of risk as permanent loss of capital.
- The best strategy for investors is to buy a broad index of securities and adjust for the desired level of risk by combining investments in this index portfolio with greater or lesser amounts of a risk-free asset, such as cash.

There were always investment professionals who disagreed with this theory, especially as their livelihood depended on its being incorrect or at least difficult for their clients to swallow. But over the last 20 years, a number of academic studies began to challenge the efficiency hypothesis. In these studies, mechanical variants of value investing (e.g., low price to earnings, low price to book value) have bested the indexes, as have some variants of momentum investing (e.g., buy stocks that have gone up and sell them before they go down). The general outcome has been to tarnish if not destroy the efficient market orthodoxy and to reinforce the worth of Graham's approach.

Along with the purely statistical challenges to modern investment theory, a body of work labeled *behavioral finance* has built on psychological research to dispute the idea that investors act as dispassionate calculating machines. It turns out that like everyone else, investors respond to events in the world with certain powerful biases. New information is interpreted, not simply digested, and not all of that interpretation is rational. One powerful set of biases tends to give more significance to the most recent news, good or bad, than is actually warranted. The stocks of companies that report high rates of growth are driven to extremes, as are stocks of companies that disappoint. These findings about excessive reactions confirm a belief that value investors have held since Graham: Over the long run, performance of both companies and share prices generally reverts to a mean. The first edition of *Security Analysis* had as a frontispiece this quote from Horace's *Ars Poetica*: "Many shall be restored that now are fallen and many shall fall that now are in honor." If value investors have their own bias, Horace captured it. Again, modern academic research has moved the theory of financial market behavior in the direction of Graham and Dodd.

More surprisingly, Graham and Dodd's insights into the methods of valuing companies have also anticipated recent developments in the field. At the core of most investment approaches lies the practice of valuation, the techniques by which the real or intrinsic value of a company can be estimated. Most investors want to buy securities whose true worth is not reflected in the current market price of the shares. There is general agreement that the value of a company is the sum of the cash flows it will produce for investors over the life of the company, discounted back to the present. In many cases, however, this approach depends on estimating cash flows far into the future, well beyond the horizon of even the most prophetic analyst. Value investors since Graham have always preferred a bird in the hand—cash in the bank or some close equivalent—to the rosier projection of future riches. Therefore, instead of relying on techniques that must make assumptions about events and conditions far into the future, value investors prefer to estimate the intrinsic value of a company by looking first at the assets and then at the current earnings power of a company. Only in exceptional cases are they willing to factor in the value of potential growth.

This skepticism regarding growth stems not from a prejudice against the future but from an understanding that in many instances growth is simply not worth very much at all. For most companies in a competitive market economy, all the value of the growth will be consumed to pay for the additional capital that is necessary to fund the growth. The growth that is profitable for investors is growth that produces returns that exceed the costs of this additional capital. As we discuss in detail in this book, the companies that produce these kinds of above-normal returns are those that operate protected by barriers to entry from competitors that would otherwise enter these profitable markets and drive down the excess profits. Growth has value only within a protected franchise. It is the rare company that can expand beyond its franchise and still retain its profitability. When value investors do try to put a value on growth, they therefore pay most attention to the strategic position of a company and attempt to assess how sustainable any current franchise is. Here suspicion rules; the burden of proof is always on those who argue that the franchise will swell and still thrive. This broad vision, now commonplace among the most sophisticated investors, that an assessment of the strategic position of a company is central to any useful valuation, is inherent in the Graham and Dodd approach.

A further advantage of the value investor's approach—first the assets, then the current earnings power, and finally and rarely the value of the potential growth—is that it gives the most authority to the elements of valuation that are most credible. Asset values depend on tangible aspects of a company's situation today. Earnings power valuations assess the value of today's earnings. It is much easier to establish with confidence the current market price of a piece of land or the current profitability of a division than it is to predict the size of a market, one company's share of that market, its profit margins, and its cost of capital 20 years, or even five, into the future. Ultimately the future does matter, but it is important to separate what we reliably know today from less secure conjectures about tomorrow. This is one of the strengths of the Graham and Dodd approach. Also, this discrete process allows investors to spot discrepancies between the asset value of a company and its current earnings power value. When this is a sign that the company suffers from poor management, some value investors have become activists to encourage management to take corrective action, sell the company, or just simply leave.

Graham loved his “net-nets,” the stocks he could buy for substantially less than the current assets of the company minus all its liabilities. Who wouldn't? But in the contemporary investment world, net-nets are, with only the rarest exception, a distant memory. Modern value investors have had to develop new approaches to discovering and valuing assets that allow them to move beyond cash, accounts receivables, and inventory while still making their investment decisions on the basis of the value of the assets today, rather than earnings, cash flow, or whatever in the future.

In the last years of the last century, it looked as if value investors were an endangered species. The “New Economy,” based on digital technologies and biotechnologies in all their manifestations, was thought to cultivate companies with prospects for unlimited growth in sales and even more growth in income. By now it is clear that at least some of these premises were mistaken. There is no need to review the history of those miraculous initial public offerings (IPOs) that came public at \$20, spiked to \$120, and then drifted or thudded back to earth, on the basis of earnings that no one had seen but were promised four or five years hence. The most fervid proponents of the New Economy hypothesis argued that some of the fundamental truths of economics had been repealed, such as the theory that competitors

would be drawn to profitable industries and ultimately force profit margins down into a normal range.

This intellectual environment, when coupled with stock markets that for three or four years only went up, and up substantially, was not friendly to value investors. Even those whose long-term performance records were the stuff of legend fell behind those who either understood the New Economy or, more likely, were able to anticipate how other investors would respond to its prospects. At the end of the decade (and century and millennium), the debate between those who saw the current market level as tulip mania revisited and those who saw it as a stepping stone to 36,000 on the Dow was still raging. It has diminished, at least for the moment, as the year 2000 reminded investors that everything that rises may not rise forever. Like most value investors, we do not put much credence in predictions about the market—our own included. But we strongly believe that the laws of economics have not been repealed, and that in a market economy, competition will, in the absence of readily identifiable barriers to entry, eventually keep profits in check. In this sort of world, which has characterized most of recorded economic history, a book that offers an updated version of the Graham and Dodd approach is hardly out of place.

This book is intended for anyone interested in investing, from the casual weekend reader of *Barron's* or something similar to the seasoned professional bearing the sobering responsibility of managing other people's money. We have assumed nothing on the part of our readers except a willingness to follow an argument and to examine some financial tables and charts. There are redundancies within this book; we excuse them on the grounds that it is easier to skip repetitions than to search back for the first time an unfamiliar concept was introduced. Though much here will be familiar to experienced money managers and academics, we believe that there are enough new ideas and novel applications of established ones to satisfy almost everyone.

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