Global Matters Weekly

19 July 2021

Value Investing Redux

by Tom Delic

Having been in consistent print since its first publication in 1949, Benjamin Graham's 'Intelligent Investor' has, along with 'Security Analysis', provided the philosophical foundation to thousands of successful investment practitioners over the decades. However, as Mark Twain said, "A classic is something that everybody wants to have read, and nobody wants to read". Open almost any page of those two texts however, and your mind will be enriched with the ideas and thoughts of Graham, and like most literature that has survived the test of time, you will soon realise why.

The concepts laid down by Graham over 70 years ago sets an investor up with a sound, rational, mental framework to deal with the vicissitudes of a hyper-active stock market, that swings between the emotions of a broken-hearted teenager and a toddler's first taste of chocolate. But what does Graham not say? Is the consensus view of value investing in line with the thinking of Graham or has time distorted and twisted the interpretation?

Leaning on the work of Eugene Fama and Kenneth French, investing is often reduced to nothing more than quantitative pigeonholing. A fund manager strategy or a point-in-time valuation ratio of a listed equity can then be boxed neatly into categories, pitted against one another in an endless race where investors are pressured to pick a side. Today, the consensus is "value" investing is losing the race, with "growth" investing in an unassailable lead. Perhaps though, there are no "style" sides and instead a footrace exists between investment and speculation, which can often feel like a marathon. This takes us back to Graham.

Graham's core tenets seek to teach us how to act like investors rather than speculators. The margin of safety concept sits at the heart of this approach and simply advises that the investor should only purchase securities where a gap exists between their conservative estimate of intrinsic value, and the price at which the security is being offered. In Graham's words, "the function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future".

The example of Microsoft provides an illustrative example of Graham's concept in practice. From 1999 to 2012, Microsoft's free cash flow yield increased from 1.6% to 13.1%[1], with equity holders of the company suffering a -42% total return over the period[2]. The speculative era of 1999 had faded away and in 2012, an opportunity for a conservative investor was available.

Value investing today is assumed to be a blind investment in the optically cheap but in 'Security Analysis', Graham emphasises that "an investment operation is one that can be justified on both qualitative and quantitative grounds". A cursory glance at the data in 2012 would have shown you that despite the share price halving since 1999, the business was fundamentally strong, with consistent revenue and cash flow growth over the period[3] and Microsoft Windows remaining the dominant operating system in an ever-increasing world of computer usage.

The narrative around the company was certainly not as rosy however, with headlines such as 'Microsoft's Lost Decade'[4] and "Microsoft once ruled the world. So, what went wrong?"[5]. Turning to Graham's principles once more, he states "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right." A margin of safety and the courage to act against the crowd would have resulted in a successful investment in Microsoft, as the investors of 2012 have handed the reins back to the speculators of 2020-21, which has seen the company move to a free cash flow yield of 2.5%.

In a period of frenzied and excitable divorcement of price and fundamental value, as we have seen over the past couple of years, the speculators rule the roost, with investors flapping for a perch. There is no universal law to help investors second guess when a change will occur. Instead, investors should stay focused on Graham's principles to ensure they are acting with a margin of safety using their own analysis. This is what value investing truly is.

Source 1, 2 & 3: Bloomberg Finance L.P.
Source 4: Vanity fair August 2012
Source 5: The Guardian, August 2021

Belvest 研富

For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

Important notes

This communication is issued by Belvest Investment Services Limited and/or Belvest related companies (collectively, and individually Belvest) solely to its clients, qualified prospective clients or institutional and professional investors. Unless stated otherwise, any opinions or views expressed in this communication do not represent those of Belvest. Opinions or views of any Belvest company expressed in this communication may differ from those of other departments or companies within Belvest, including any opinions or views expressed in any research issued by Belvest. Belvest may deal as Distributor or Agent, or have interests, in any financial product referred to in this email. Belvest has policies designed to negate conflicts of interest. Unless otherwise stated, this e-mail is solely for information purposes.

This message may contain confidential information. Any use, dissemination, distribution or reproduction of this information outside the original recipients of this message is strictly prohibited. If you receive this message by mistake, please notify the sender by reply email immediately.

Unless specifically stated, neither the information nor any opinion contained herein constitutes as an advertisement, an invitation, a solicitation, a recommendation or advise to buy or sell any products, services, securities, futures, options, other financial instruments or provide any investment advice or service by Belvest.

No representation or warranty is given as to the accuracy, likelihood of achievement or reasonableness of any figures, forecasts, prospects or return (if any) contained in the message. Such figures, forecasts, prospects or returns are by their nature subject to significant uncertainties and contingencies. The assumptions and parameters used by Belvest are not the only ones that might reasonably have been selected and therefor Belvest does not guarantee the sequence, accuracy, completeness or timeliness of the information provided herein. None of Belvest, its group members or any of their employees or directors shall be held liable, in any way, for any claims, mistakes, errors or otherwise arising out of or in connection with the content of this e-mail.

This e-mail and any accompanying attachments are not encrypted and cannot be guaranteed to be secure, complete or error-free as electronic communications may be intercepted, corrupted, lost, destroyed, delayed or incomplete, and/or may contain viruses. Belvest therefore does not accept any liability for any interception, corruption, loss, destruction, incompleteness, viruses, errors, omissions or delays in relation to this electronic communication. If verification is required please request a hard-copy version. Electronic communication carried within the Belvest system may be monitored.