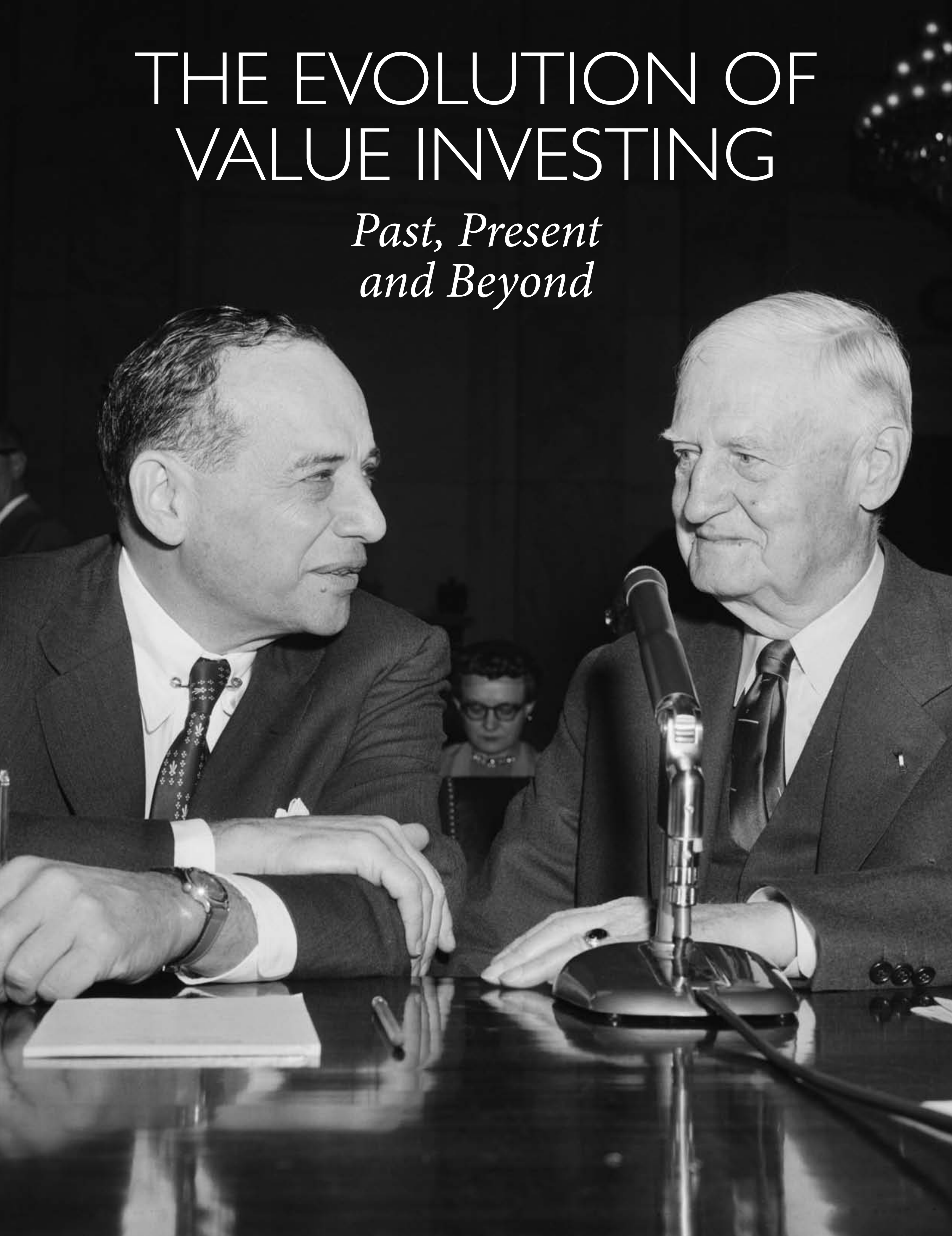
THE EVOLUTION OF VALUE INVESTING

Past, Present and Beyond



Benjamin Graham (left) with General Robert E. Wood, 1955.

**By Joseph Calandro, Jr.
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Considering the popularity of value investing, it is somewhat surprising that a paper recently published by Joseph Calandro in the *Journal of Investing* was the first formal attempt to categorize the development of this highly-effective and influential school of thought over time. The following article summarizes this categorization of value investing's past and present and offers suggestions on what its future may hold.

Founding Era: 1934 to 1973

The "official" founding of value investing can be dated to 1934 with the publication of Benjamin Graham and David Dodd's seminal book, *Security Analysis*. The strategic concept upon which value investing was founded is as insightful as it is simple; namely, that assets purchased at prices for less than their liquidation value (estimated as current assets less total liabilities or "net-net value") provide an opportunistic and relatively low risk form of investment (where *risk* is defined as the possibility of loss) due to the "margin of safety" afforded by the discount from liquidation value.

Over time, some investors would come to base margins of safety off of earnings power and even growth value in addition to the balance sheet. Exhibit 1, taken from Professor Bruce Greenwald's popular book *Value Investing: From Graham to Buffett and Beyond*, profiles the different approaches of modern value investing, as well as some of the professionals associated with each approach as of the book's publication.

The cornerstone of value investing has always been, and will always remain, firmly grounded in the margin of safety principle, regardless of how any specific margin may be estimated. The Founding Era effectively ends with the publication of the 1973 edition of Graham's immensely popular book, *The Intelligent Investor,* which distills lessons from *Security Analysis* to a non-professional audience. Shortly after the book's publication, in 1976, Graham passed away at the age of 82.

Post-Graham Era: 1973 to 1991

The start of the Post-Graham Era coincides with the great 1973–74 bear market which, amongst other things, presented numerous investment opportunities akin to those

Exhibit 1: Approaches to Value Investing

CLASSIC	MIXED	CONTEMPORARY
Graham	**Gabelli**	**Buffett**
Tweedy, Browne	**Neff**	**Greenberg**
Schloss & Schloss	***Price***	***Ruane, Cuniff***
Heine	Royce	
Heilbrunn	Greenblatt	
Klarman	Whitman	
Sonkin		
Diversified portfolio	Replacement value	Concentrated portfolio
Tangible assets	Sufficient research	Intense research
Cursory research	Private market value	Franchise value
Unpresentable	Catalyst	Attractive but not sexy
"Wounded ducks"	Relative value	Owning the business
In the shadows	Bland	"Wounded eagles"
	Normalized earnings	Hiding in plain site
	Temporarily offstage	

Source: Bruce Greenwald, et al., *Value Investing: From Graham to Buffett and Beyond* (NY: Wiley, 2001), p. 159.

seen at the beginning of the Founding Era. Therefore, it was not coincidental that such a market environment saw the ascendancy of a number of highly-successful value investors such as Gary Brinson, Jeremy Grantham, John Neff and others.

Nevertheless, it was during this period that modern financial economic theories were beginning to take hold. In his bestselling book, *Capital Ideas,* Peter Bernstein summarized these theories, all of which tend to find disfavor with professional value investors. For example:

- Economists believe that markets are "efficient," while value investors know that, at times, markets can behave extremely inefficiently;
- Economists believe that capital structure is "irrelevant," while value investors know that capital structure is *always* relevant (for example, a company financed with 100% debt is quite different from one financed with 100% equity);
- Economists believe that investments should be guided by modern portfolio theory and asset pricing models, while value investors understand, and carefully exploit, the fact that volatility and statistical measures of it are *not* risk; and
- The option pricing models of financial economics do not consider underlying value; conversely, to a value investor, value is a component of option pricing just like it is a pricing component for every other economic good.

Despite the success of professional value investors during this era, the challenge for the school's theorists and practitioners was to determine how the basic insights of value investing could be reinterpreted for modern investors, and to demonstrate the significance of that reinterpretation given the market conditions investors were wrestling with.

Modern Era: 1991 to Present

To address the above challenge, value investor Seth A. Klarman, co-founder and president of The Baupost Group, picked up where Graham left off. The 20th and final chapter of *The Intelligent Investor* is titled, "'Margin of Safety' as the Central Concept of Investment," while the title of Klarman's 1991 book is *Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor.* The lucidity of Klarman's book, coupled with his investing track record, set the tone for the Modern Era of value investing.

Support for this position can be found in the influence that *Margin of Safety* has had on all of the prominent value investing books that were published after it, from Bruce Greenwald's aforementioned book (chapter 13 of which profiles Klarman), to the sixth edition of *Security Analysis* (for which Klarman served as lead editor) to Howard Marks's recently-published value investing book, *The Most Important Thing Illuminated* (which was endorsed by, and contains annotations from, Klarman).

One of the strengths of modern value investing theory is that it can be applied to all forms of investments, not just stocks and bonds. For example, consider derivatives. Bestselling books, like Michael Lewis's *The Big Short,* demonstrate that a number of investors really did "catch" the recent financial crisis by purchasing credit default swaps (CDS) at margin of safety-consistent prices prior to the crisis. Significantly, one of those investors was Klarman. How did the investors do it?

While the specifics of their investments are not publicly available, there is a real-time record of similar investments in the influential and long-running value investing newsletter, *Grant's Interest Rate Observer*, published by investor/historian/financial analyst/journalist James Grant. A compendium of Grant's newsletters leading up to "the big short" was published in a bestselling book titled *Mr. Market Miscalculates* (Mr. Market being Graham's euphemism for the short-term-oriented trading environment that dominates the financial markets). On page 171 of the book, which was taken from the September 8, 2006 edition of *Grant's Interest Rate Observer*, it was noted that a hedge fund was "expressing a bearish view on housing in the CDS market by buying protection on the weaker tranches of at risk mortgage structures. At the cost of $14.25 million a year, the fund has exposure to $750 million face amount of mortgage debt."

To see how margin of safety-rich this investment was at the time, consider the following: one way that commercial insurance companies evaluate risk pricing is to divide the premium of risk transfer (in this case, $14.25 million) by the amount of risk being transferred (in this case, $750 million), which here gives a "rate on line" of $0.014. By comparison, it is not uncommon for many businesses to pay $40,000 or more per year for $1 million of general liability insurance, which equates to a "rate on line" of $0.04.

Post-Modern Era

With value investing being applied to so many asset classes—stocks, bonds, real estate, derivatives, etc.—what could a "Post-Modern Era" possibly entail? The future could witness the application of core value investing principles, especially the margin of safety principle, to corporate management.

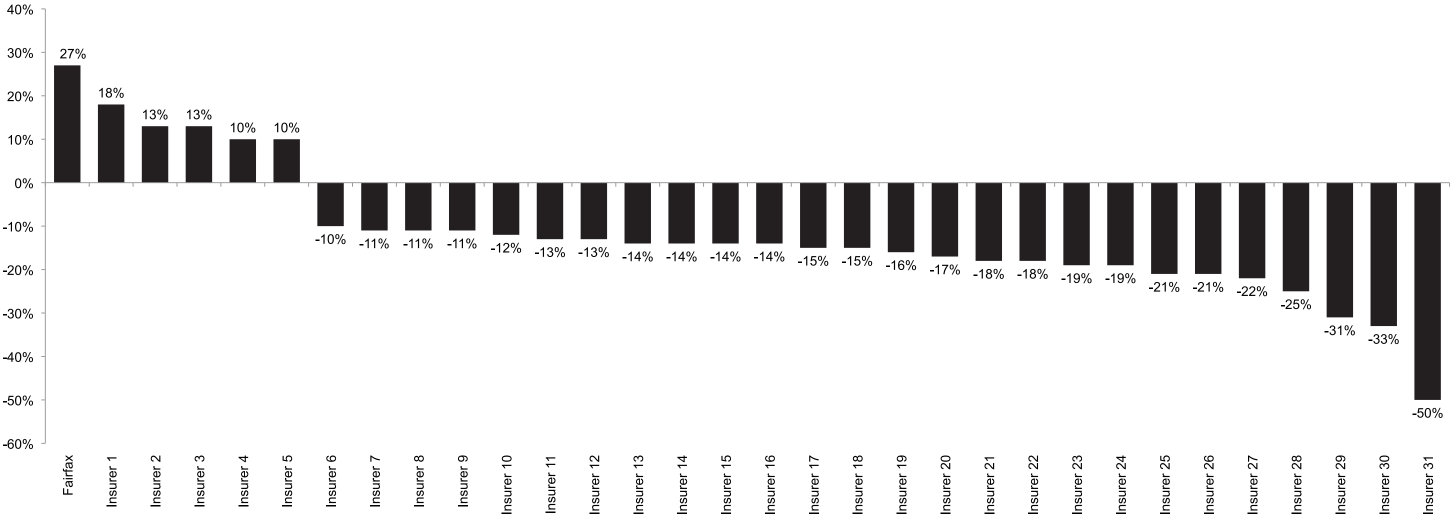
Throughout their history, value investors have been skeptical of corporate managers. For example, in *Security Analysis,* Graham and Dodd observed that "It is nearly always true that the management is in the best position to judge which policies are most efficient. But it does not follow that it will always either recognize or adopt the course most beneficial to the shareholders. It may err grievously through incompetence." In modern times, this can be seen in many corporate risk management activities.

Since the recent financial crisis, many government regulators have focused on enacting a wide variety of controls, conducting "stress tests" and ensuring that highly-leveraged firms have enough capital on hand to satisfy their liabilities. Therefore, a great deal of corporate risk management activity is undertaken to ensure compliance with various governmental mandates. Unfortunately, much of this activity involves simply documenting what firms are already doing to manage risk, which in some cases may not be very effective given the condition of certain corporate balance sheets. Therefore, it makes a great deal of intuitive sense to "stress test" those balance sheets.

Regardless of its intuitive appeal, many stress tests are informed by Value-at-Risk models, and their "economic capital" outputs, even though it is well-known that these models are thin-tailed and thus "at risk" of underestimating actual stressful market environments.

Furthermore, once a government entity specifies either a risk mandate and/or capital standard it tends to become *the* market standard. An unintended consequence of this is that firms seen to comply with governmental standards often begin to incrementally expand their risk appetites in manners frequently deemed *de facto* appropriate given

Exhibit 2: Margin of Safety-based Hedging



Source: Dowling & Partners, *IBNR Weekly #39,* October 5, 2007, p. 8. The names of the remaining 31 insurers are available from Dowling.

the compliant status of the firms in question, regardless of the effect that expansion has on their risk profiles over time.

To make matters worse, the above considerations often interact, thereby magnifying potential losses. Consider the case of Enron, whose "quants" pegged the amount the firm could expect to profit from or lose at $66 million in a single day, within a 95% probability. According to Frank Partnoy, author of *Infectious Greed*, "Enron's VAR measure was based on the inordinately smoothed profits its traders reported; in reality, the volatility of its trading range was much greater [than $66 million]. In fact, traders frequently made and lost more than their reported VAR; on a single day during 2000, traders made more than $500 million. On December 12, 2000, they lost $550 million." Such dynamics obviously magnified Enron's risk profile prior to its historic failure.

In light of the above, is it any wonder why Graham and Dodd generally felt the way they did about corporate managers? Fortunately, not all firms are managed the same way. Consider, for example, the case of value investor Prem Watsa, the founder, chairman and CEO of Fairfax Financial Holdings. Prior to the recent financial crisis, Watsa also purchased economically priced CDS, and those purchases reportedly generated a gain of more than $2 billion against an investment of $341 million. While the specifics of Watsa's position are not publicly known, one can surmise that because he is a corporate manager, the CDS he purchased were appropriate for the balance sheet he was managing, which is to say hedging.

In general, there are three ways to manage the risk of a significant balance sheet concentration: (1) reduce it, (2) diversify it or (3) hedge it. Each of these alternatives can be informed by value investing in general and by the margin of safety principle in particular. In the case of hedging, the result of Watsa's hedge speaks for itself: Exhibit 2 profiles 10% or greater changes in property and casualty insurance company performance in the third quarter of 2007. The financial performance of Fairfax Financial Holdings — shown at the extreme left of the exhibit — is materially greater than the rest of the insurance industry.

For another example of how to apply value investing to corporate management, consider mergers and acquisitions (M&A). It is well-known that many corporate M&A deals fail to create the value expected at the time they were announced. It is also well-known that the primary reason for these failures is that the transactions occur at price levels that are simply too high; in other words, the deals do not contain a margin of safety. Given the nature of private market values and the control premiums contained therein, many executives apparently believe that value investing principles cannot be applied to M&A. One can, of course, cite examples of Warren Buffett's various acquisitions here, but Buffett is primarily an investor. Fortunately, there are corporate management-specific examples as well.

First and foremost, consider the case of the late Henry Singleton, Ph.D., who was the founder, chairman and CEO of Teledyne Corporation. According to investment advisor and author John Train, "Buffett considers that Henry Singleton of Teledyne has the best operating and capital deployment record in American business." Leon G. Cooperman, the founder, chairman and CEO of Omega Advisors, was both an investor in Teledyne and a student of Dr. Singleton's strategies and management practices for decades, which he insightfully summarized in a seminal study that was presented to the New York Society of Security Analysts in 2012.

Consider also the case of the late Larry Tisch, who was the co-founder, chairman and CEO of Loews Corporation. As Christopher Winans reflects in his aptly-titled book, *The King of Cash,* Tisch and his brother Bob founded, built and managed their highly-successful company in a margin of safety-oriented manner, especially with respect to M&A and cash management.

To understand how value investing can practically be applied to corporate M&A, consider that because its valuations are built from the bottom-up, all value investing assumptions are completely transparent. As a result, assumptions requiring clarification are natural candidates for formal due diligence. Additionally, the M&A information generated from the value investing process can be compared with the known drivers of value realization risk to determine if a deal's private market value offers a margin of safety even considering its control premium.

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Value Investing

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Bach, Graham and Beyond

Classifying the different eras of a popular school of thought is a subjective endeavor, and as such frequently requires anchoring to key dates. For example, the Baroque Era of music "officially" ended with the death of J.S. Bach. Maestro Bach, of course, never knew that his death would end an era any more than Benjamin Graham could have known that some future authors would date the close of the Founding Era of value investing with the 1973 edition of his classic book, *The Intelligent Investor*. Nevertheless, such classifications are useful for both practitioners and researchers, especially when contemplating what the future may hold.

Whether the future develops as we have theorized, and value investing comes to influence and define corporate management or not, investors and corporate managers can benefit from studying the lessons of Graham and his followers over time. Their school of thought has been applied to a variety of asset classes and market environments and, when it has been applied skillfully, it has helped to produce exceptional returns at relatively low levels of risk. $

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New Bedford

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was passed in 1994. New Bedford-based banks were all but obliterated by the financial industry's consolidation.

Big banks with national or regional footprints now dominate the local scene. Even many of the city's lesser-known banks are headquartered elsewhere. Admiral's Bank is out of Boston; BCP is headquartered in New Jersey; Eastern Bank is from Salem and Webster Bank from Waterbury. That has hurt the city's efforts to rebound because the remaining institutions — St. Anne Credit Union, BayCoast Bank, Bristol County Savings and St. Anthony-New Bedford Federal Credit Union — are too small to matter much to large or growing businesses.

The second largest bank, BayCoast, barely had $1 billion in assets as of the end of the first quarter of 2014 and the largest, Bristol County Savings, had assets just over $1.5 billion at that time. While a billion may sound like a lot, 101 US financial institutions had assets greater than $10 billion at the end of May 2014. St. Anne dates back to 1911, a long time for a credit union, but it has assets of only about $18 million. And like other credit unions, it can't lend much to businesses.

New Bedford and its surrounding area was heavily taxed and regulated and largely devoid of local innovative sparks as most of its banks, insurers, hospitals and universities were mere branches of institutions headquartered elsewhere. Much of the indigenous human and financial capital, once copious, has long since passed on or moved away. The city is currently in dire need of some "Rotches," not the six-legged variety, but people with money and business acumen who care about the community and can command sizeable sums through intermediaries. $

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