The value of value investing

With the right approach, value investing can generate rather attractive returns and beat the S&P 500 Index by a wide margin.

Margin of safety

Warren Buffett started investing at the age of 11, and his wealth has grown to well over $100 billion through smart investing. Buffett's investment method is called value investing, where investors buy financial instruments, mostly stocks, that can be bought for less than their "real value". This 'real value' is also known as intrinsic value or underlying value. There are different ways of calculating this intrinsic value, but the bottom line remains that instruments are bought at a discount to this "real value".

An extreme form of value investing, called deep value investing, illustrates the idea. If you can buy a company on the brink of bankruptcy for €1,000 and its equity (assets minus liabilities) is €5,000, you can't help but make money. In fact, there are two outcomes: 1. The company goes bankrupt, you sell the assets, pay off the debts and walk away with 5,000 euros (400% return), 2. The company survives, does very well and pays out profits for years.

Warren Buffett is one of the most famous and successful value investors. Although his long-term returns have been very good and well above the S&P500, he achieved his greatest successes early in his career. At the time, he was following the principles of his teacher Benjamin Graham, who believed that investors were focusing too much on a company's earnings rather than its assets and liabilities.

Graham bought stocks with a "margin of safety", where the difference between value and price mattered. Buffett said: "Price is what you pay. Value is what you get. Investors achieve a margin of safety by buying shares at the highest possible discount to a stock's true value. Buffett likens this idea to buying a dollar for 60 cents: "If you buy a dollar bill for 60 cents, it's riskier than if you buy a dollar bill for 40 cents, because the profit expectation is higher in the latter case. The higher the upside in a value portfolio, the lower the risk.

Berkshire Hathaway

Buffett started out in 1950, at the age of 20, with an initial capital of just under $10,000, which grew to $140,000 in six years. He then set up his own investment fund in 1957 and, using the principles of his teacher[1], achieved annual returns of over 30% in 12 years.

Year	Overall Results From Dow (1)	Partnership Results (2)	Limited Partners' Results (3)
1957	-8.4%	10.4%	9.3%
1958	38.5%	40.9%	32.2%
1959	20.0%	25.9%	20.9%
1960	-6.2%	22.8%	18.6%
1961	22.4%	45.9%	35.9%
1962	-7.6%	13.9%	11.9%
1963	20.6%	38.7%	30.5%
1964	18.7%	27.8%	22.3%
1965	14.2%	47.2%	36.9%
1966	-15.6%	20.4%	16.8%
1967	19.0%	35.9%	28.4%
1968	7.7%	58.8%	45.6%

In 1965, Buffett acquired the textile company Berkshire Hathaway, which eventually became his investment vehicle. Together with his friend and partner Charlie Munger, Berkshire Hathaway continued to be a great success, although the returns were not as good as in the early years and success began to wane. This was partly because Berkshire's capital continued to grow and it became more difficult to put the huge capital to work.

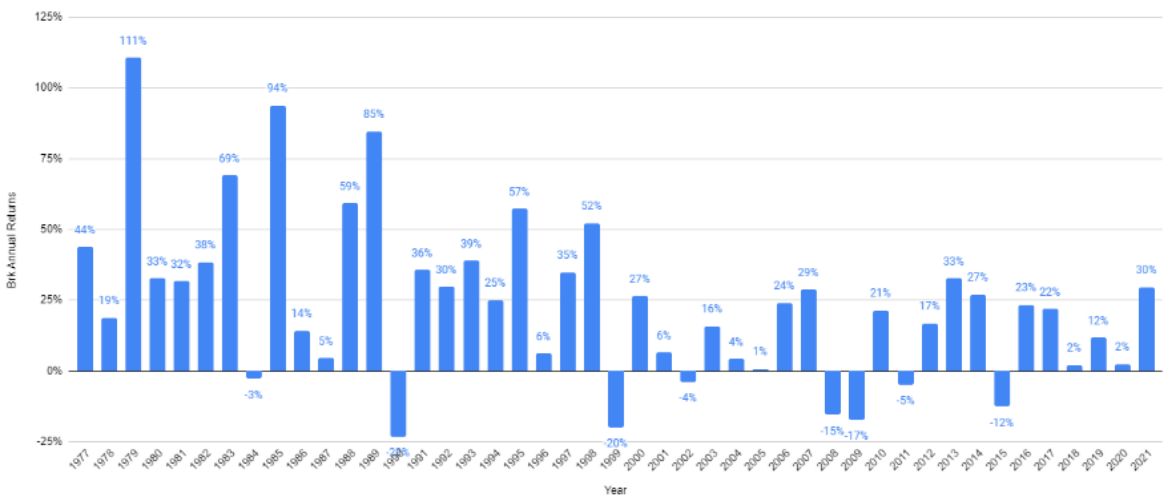
Nevertheless, the average return between 1965 and 2023 was a very nice 19.8% per annum, while the average return for the S&P 500 was 10.2%. As mentioned, returns have been falling and between 2014 and 2023 Berkshire's average return was not exceptionally high at 12.5% per annum, roughly the same as the S&P 500.[2] The chart below clearly shows that the high positive outliers are receding.[3]

[1] Buffett Partnership Relative Results 1957 – 1968. Source: *Buffett Partnership Letters*

[2] https://www.berkshirehathaway.com/letters/2023ltr.pdf

[3] https://kunaldesai.blog/berkshire-hathaway-returns/

Berkshire Hathaway Annual Returns Chart



The Acquirer's Multiple

One investor who has done a lot of research into the returns of different value investing strategies is Tobias Carlisle. He wrote a book called "The Acquirer's Multiple" in which he compares different strategies. He developed a relatively simple financial indicator (multiple) to find undervalued companies:

Enterprise Value / Operating Earnings

This indicator takes into account several things that other indicators such as the P/E ratio do not, including debt, preference shares and minority interests. Benjamin Graham said that investors focus too much on earnings and not enough on debt. This method takes debt into account and incorporates it into enterprise value.

The lower the result of the above indicator, the cheaper the stock. By buying the cheapest stocks (i.e. those with the lowest scores on the indicator) and rebalancing regularly, this strategy (with stocks starting at a market value of $50 million) produced an average annual return of 18.5% between 1973 and 2017. This compares with an average return of 7.1% for the S&P500 over the same period.

He also included other strategies for comparison, such as The Magic Formula and Pure Charlie. The Magic Formula is a value strategy developed by Joel Greenblatt. This strategy looks at two indicators, earnings yield (inverse P/E) and return on capital. This strategy has returned 16.2% over the same period (1973-2017). This is also a very good return, but less than the Acquirer's Multiple, which returned 18.5%.

What made the Acquirer's Multiple beat the Magic Formula? The answer is mean reversion, or reversion to the mean. Stocks tend to return to their historical averages over time. When stocks are selected on the basis of historical profitability, as in the Magic Formula, returns are lower.

To demonstrate this, Carlisle developed a strategy that only bought stocks with the highest earnings, ignoring value. He called this strategy Pure Charlie, in honour of Charlie Munger's Poor Charlie from Poor Charlie's Almanac. Pure Charlie is the opposite of the Acquirer's Multiple. This method is purely profit-oriented and revolves around the return on invested capital. It buys the thirty stocks with the highest earnings and is not concerned with value. Over the same period (from 1973 to 2017), this strategy generated an average annual return of 15.1%. Still a nice return, but less than the returns of the value strategies the Acquirer's Multiple and the Magic Formula.

Average annual return 1973-2017, market cap >$50 million:

- S&P 500 7,1%
- Pure Charlie 15,1%
- Magic Formula 16,2%
- Acquirer's Multiple 18,5%

So it is possible to beat the S&P 500 by a significant margin over the long term, especially if the right value strategies are used. However, not every year is a great one. In its first year (1973), the S&P 500 returned -16.8%, while the Acquirer's Multiple performed much worse: -37%. During the 2008 crash, the S&P 500 fell by 40% and the Acquirer's Multiple also fell sharply. Admittedly less, but still quite a lot at -29.3%. However, this loss was more than made up for the following year with a return of 91%, while the S&P 500 rose by "only" 30%.[4]

Conclusion

Investing involves risk and there is no guarantee of success, but those who follow the principles of value investing well and have the time (preferably at least 10 years) to invest, can achieve very attractive returns. In addition, value investors can outperform widely used indices such as the S&P 500.

[4] Carlisle, T. (2017). *The Acquirer's Multiple: How the Billionaire Contrarians of Deep Value Beat the Market*