What is Value Investing?
Here's what my teacher says.

By Eugeniu Guzun – HedgeNordic

"My target holding period is forever. That forces me to buy assets that strengthen with time, ones that Nassim Taleb would call antifragile."

Most value-oriented fund managers I've met say they were introduced to value investing by Benjamin Graham through his legendary book "The Intelligent Investor." I consider myself to be a value investor; not a professional one, of course, but a value investor still. But my introduction to the field didn't come from Graham. It came from Kenneth Jeffrey Marshall, an author, professor, and value investor. For seven years he has taught the subject in the masters in finance program at the Stockholm School of Economics, as well as at Stanford University. I attended his two courses at the Stockholm School of Economics, and it was there that I fell in love with the discipline.

Value investing is often understood only vaguely, with great imprecision. But in the classroom Marshall provided a straightforward, essential guide. He was an encyclopedia on the subject for me and many of my peers. So I was sure my former teacher would again clarify it for me, and perhaps for others as well. As Marshall tells HedgeNordic, value investing is just "buying assets for less than worth. I get no creativity points for that one."

KENNETH JEFFREY MARSHALL,
AUTHOR, PROFESSOR,
VALUE INVESTOR

Indeed, the notion of buying something for less than its worth is perhaps the essence of value investing. And that something could be anything: a fast-growing company, a struggling business, a used excavator, or a Van Gogh painting. But Marshall adds that some might lengthen his definition. "They might add '...and selling assets for more than worth.' That wouldn't be wrong. But selling isn't my game."

Even though Marshall has taught at university since 2013, he notes that "academia ain't really my papa. The market is." He first learned about value investing thirty years ago from a childhood friend, whose father had started a value fund back in 1979. "When we graduated from college in 1989, my friend went to work for that fund," Marshall says. "He started sharing with me all kinds of value insights, talking about fundamental analysis, Omaha, the Wesco meetings in Pasadena—all of it." Marshall started investing on his own in 1990.

Marshall is the author of the book Good Stocks Cheap: Value Investing with Confidence for a Lifetime of Stock Market Outperformance published in 2017 by McGraw-Hill. I've been using it as my investing bible since I took his class. The book lays out Marshall's approach, which is simple and intelligent. "I buy good stocks cheap. That's it," he explains. "So there's a lot that I don't do. I don't buy anything expensively, I don't buy bad assets at any price, and I don't sell," he says. "That leaves me with a pretty small sphere of activities to get right."

His no-selling policy stands out. "My target holding period is forever. That forces me to buy assets that strengthen with time, ones that Nassim Taleb would call antifragile." For that reason, macroeconomic considerations don't dominate his decision making. "Forever is going to include a lot of different macro environments. It's going to have high and low interest rates, booms and recessions, high unemployment and full employment." Marshall therefore hunts for companies that will thrive under all sorts of conditions. "I don't spend time trying to guess who's going to win an election, or what interest rates will be, or anything like that," he states.

The Value vs. Growth Distinction: Fuzzy Thinking

Analysts, fund managers and many others usually differentiate between value and growth investing. But Warren Buffett has referred to that distinction as fuzzy thinking. Unsurprisingly, Marshall agrees with the master. "It's fuzzy because, in truth, you want both. You just want to make sure that each term describes the right thing," he says.

"You want value to describe price, and you want growth to describe value. You want to buy a listed equity at a price that makes it a value even if earnings and free cash flow trudge along at some modest run rate. But then once you own the stock, you want earnings and free cash flow to really skyrocket."

Three Reasons Why Value Investing Has Underperformed

The value investing style has lagged the growth investing style since the financial crisis. Marshall sees three reasons for this. "First is the light regulation of many so-called growth companies" like internet media firms. "Most of the big ones are in the United States, where they have a huge domestic market," he states, adding that "in that huge domestic market they are considered platforms, not publishers." This distinction "relieves them of many of the burdens that old-school media companies shoulder."

"Newspapers are responsible for the content on their pages," whereas social media sites are less responsible. As a result, social media firms "are not terrified by libel lawsuits, so they spend relatively less on editing, which gives them a cost advantage," explains Marshall. "American online retailers have also enjoyed light regulation," he adds, since online retailers did not have to collect sales tax for years. Consequently, "consumers who managed to get free shipping—which was not hard—got better deals from the web than they did from physical stores."

Marshall's second reason for the underperformance is the composition of benchmark indexes, many of which are market-weighted. As a company's market cap grows, it becomes a bigger and bigger part of indexes. "This makes indexes start to act a bit like momentum funds, momentum funds fuelled by the ballooning prices of lightly regulated internet companies," he argues. "Benchmarked against this orgy, value lags."

Kenneth Jeffrey Marshall is an author, professor, and value investor. He teaches value investing in the masters in finance program at the Stockholm School of Economics in Sweden, and at Stanford University. He also teaches business at the University of California, Berkeley. Marshall holds a BA in Economics, International Area Studies from the University of California, Los Angeles and an MBA from Harvard University.

His third reason is the bull market. "Value underperforms in bull markets," notes Marshall. "That's established. It's when things crash that value really shines," he emphasizes. But that shining may already be happening. Marshall stresses that while many value-oriented managers have been trailing in recent years, "many of the underperforming value funds are really deep value funds," based on a predominantly quantitative approach. "But remember that there are plenty of value portfolios that consider qualitative factors like moat, customer breadth, and the threat of new entrants. Many of those portfolios are private. They don't report. And they've been doing fine."

Is Value Investing Dead?

I often hear claims that value investing is dead. But Marshall argues that that's impossible. "Let's say that value investing is dead," he hypothesizes. "That would mean that the inverse of value investing is alive. That inverse would be buying assets for more than worth. The path to success would be overpaying. Could that ever be true?" He sees the answer as self-evident: "No."

"Admittedly, there are issues around the definition of worth," reckons Marshall. "It's hard to gauge the worth of an unprofitable enterprise in a new industry that just had its IPO." But he thinks that some fund managers do that well. "They are able to calibrate the worth of such a venture, and to buy it for less," says Marshall. "That is value investing."

The rise of technology giants may have challenged quant-heavy, deep value investors and fund managers. "This is because of how accounting rules force companies in new industries like internet media to report," explains Marshall. "Some transactions that get expensed might be more meaningfully capitalized and depreciated. So purely quantitative value strategies could have a tougher time."

"But it has always been easy to get misled by numbers alone," stresses Marshall. That's why he obsesses over what some might consider to be softer considerations. "I'm very interested in sustainable competitive advantage," says Marshall. "It's just harder to get caught in a value trap when you think about qualitative factors. Not impossible, but harder."