Value Investing

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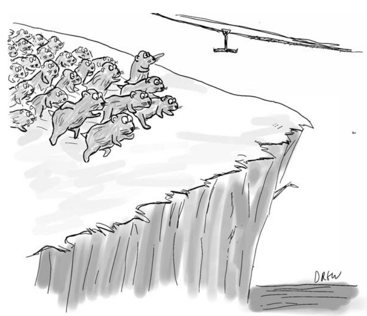
What is Value Investing?

- Value Investing: Investing in cash flow generating securities in hopes of convergence with its intrinsic value
    - Intrinsic value will prevail over the long term, unlike short term fluctuations
    - Hopes in stock price movement without regard to intrinsic value is speculation
    - Good business at a great price or buying great business at good price?



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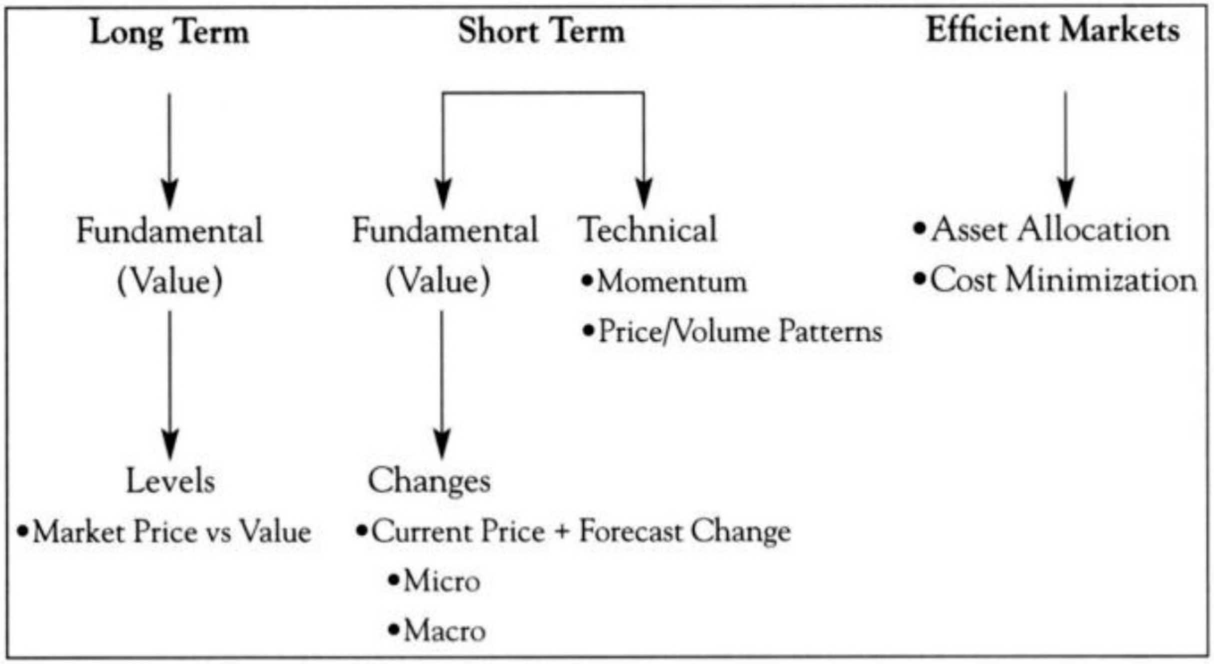
Long Term
Short Term
Efficient Markets
Fundamental (Value)
Fundamental (Value)
Technical
•Momentum
•Price/Volume Patterns
•Asset Allocation
•Cost Minimization
Levels
•Market Price vs Value
Changes
•Current Price + Forecast Change
•Micro
•Macro

Arguments For and Against Value Approach

Pros:

- Higher upside, Freedom
- Returns are scalable
- Slightly underperform during upturns, greatly overperform during downturns

Cons:

- Must be contrarian
- You don't know when you'll outperform
- No flashy returns
- You will most likely be wrong in the short term

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What makes a Business Great?

- Great businesses have:
  - Resilience towards market swings
    - Recurring Revenue
    - Strong Moat
    - Pricing Power
  - ROIC > WACC
  - Strong management
  - Runway for growth

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Where Do We Find Great Businesses?

- Ugly industries
- Boring industries
- Small firms
- Troubled firms
- Industries that require specialized knowledge (Circle of Competence)

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When Does Growth Matter?

- ROIC vs. WACC
- Growth provides tangible value only when value created > investment needed for growth (CapEx, changes in NWC, R&D, etc.)
- Expanding into new markets only makes sense of CA carries over
- Most sustainable growth is pulled by demand (q), not company (p)
- Growth doesn't save a dying firm
  - First-mover advantages (?)

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Competitive Advantages

Competitive advantages allows a firm to beat its competition in pricing and prevents them from gaining market share.

Demand Advantages

- Customer captivity
  - Habit / Brand loyalty
  - Switching costs
  - Searching costs
- Network effect
- Temporary, demand (your customers) will change over time

Supply Advantages

- Lower input costs
- Proprietary technology (patents)
- Knowledge / expertise
- Also temporary
- Best in slow moving industries

Economies of Scale

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How are EoS Different From Competitive Advantages?

- Far longer lived and therefore far more valuable
  - Think Coca Cola

When do EoS Matter?

- T-shirt manufacturer vs. Software company
  - Where EoS / scale does **not** matter: market in which all firms have equal access to customers and common cost structures

Requirements for EoS

- Cost structure
  - In order to have economies of scale, cost structure must be mainly fixed, with low variable costs
  - T-shirt manufacturers cannot have economies of scale. Software company is 100% economies of scale
- Access to customers
  - If an entrant has equal access to customers as the incumbents have, it will be able to reach the incumbents' scale. For economies of scale to serve as a competitive advantage, then, they need to be coupled with some degree of incumbent customer captivity
- Examples of poorly defended: Japanese cars entering US market
- Examples of well defended: MSFT
- Works especially well in smaller markets
  - 1. No one dares enter market 2. If they do enter, incumbent and entrant would not have enough business

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Defending EoS

- As competitors' market share becomes larger, it realizes more economies of scale and simultaneously erodes those of the incumbent
- The best course is to establish dominance in a local market and then expand outward from it
- But not all niches are equally attractive. An attractive niche must be characterized by customer captivity, small size relative to the level of fixed costs, and the absence of vigilant, dominant competitors
- Defense mechanisms: 1. Passive 2. Anything that will shift costs away from variable to fixed. Examples of the second approach include:
  - CapEx for operational efficiency
  - Spending more on advertising campaigns
  - Investing more into R&D and product development
- Careful: mindlessly growing in markets where they were newcomers battling powerful incumbents hurts the company. Must stay within your areas of expertise and competitive advantage and localized EoS

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Size, Growth, and EoS

- Pure size is not the same thing as economies of scale, which comes from being able to spread fixed costs to a greater number of units than its rivals
  - The relevant market is the area in which fixed costs stay fixed. Distribution infrastructure, advertising expenditures, and store supervision expenses are largely fixed for each metropolitan area or regional cluster.
  - Network effect: customers gain by being part of densely populated networks, but the benefits and economies of scale extend only so far as the reach of the networks
- E.g. Aetna HMO has much larger subscriber base, but Oxford Health Plans dominate in NY. Think about TransAlta, ConEd, etc.

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Size, Growth, and EoS

- Growth of a market is generally the enemy of competitive advantages based on economies of scale
- As a market grows, fixed costs stay fixed but variable costs increase, making the cost structure more biased towards variable costs and thus eroding economies of scale
- E.g. automobile market has grown so large that many competitors have reached a size at which they are no longer burdened by EoS disadvantage

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Scale Economies Shared

- Business model that shares the benefits of EoS with customers, typically offering lower prices to gain long-term market share
  - Companies grow through giving more back
  - Amazon / Costco
  - Counter-intuitive actions whereby profit or growth is seemingly unnecessarily sacrificed in pursuit of the mission
    - Rockefeller example
- Steadfast, cultural pursuit of a sacred mission

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Scale Economies Shared

- "Customer is leased, not owned"
- Organizations should orient around a sustainable competitive advantage and find people that value it

Customers will want the lowest cost

Customers will want speed

Customers will want transparency

Customers will want the best all-round user experience

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Scale Economies Shared

"Our judgment is that relentlessly returning efficiency improvements and scale economies to customers in the form of lower prices creates a virtuous cycle that leads over the long term to a much larger dollar amount of free cash flow, and thereby to a much more valuable Amazon.com."

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