Value-investing for common investors

Investing in stocks as always remains an exciting pursuit. In this investment world, stock-quotes command constant attention, where buyers and sellers of stocks generally have no idea of the businesses behind the papers they swap. As Mr Warren Buffet has said " quotations are the quotidian diet of the day trader, forging a casino culture where quickness of action fed by irrational impulses displaces quality of thought ". Generally a person puts importance on stock price and ignores the business value. The value investor focuses on value first and then compares value to stock price to see if an investment holds the promise of a good return. General investors enter stockmarket in good time and exit in bad time. Value investors acts just opposite. Now what is value investing? In pure Grahamian way (Benjamin Graham was the initiator of "value-investing" concept) it is "Cigar – butt" investing. A smoker always leaves one/two puff in the butt of the cigar after he finishes the smoking. Value-investing is to gather the thrown cigar and takes the remaining puffs. It may sound crude but that's the essence of value-investing in its purest form. Basically, value-investing aims to put common sense back to the business of investing in an age of volatile markets and colliding ideas. One must have heard people commenting " market is overvalued or market is undervalued. This is an empty statement. Any stock has its intrinsic value. It is the sum of all cash flows that it will generate in future, discounted to the present values. For a common investor assessing this is difficult, but that defines value.

Now let us try to jot down in simple terms, the tenants of value-investing :

- Value investing is about curtailment of risk - how not to lose money in the market. As one of the highly acclaimed investment experts Mr Will Rogers has once said –"***I am more concerned about the return of my money than the return on my money***". Protecting the capital is of paramount importance and return on the corpus will follow automatically. I think that sounds quite interesting given the current backdrop - what's happening around us through the last two –three months in the stock market. Buying a stock with lots of "margin of safety" is extremely important. One should not invest merely on the basis of tips. Each investment decision should be preceded with substantial time spent with company's balancesheet, its business scenario and its past performance. Value investing requires immense patience, discipline and a strong sense of self-belief. Through value investing, we will primarily concentrate on two things – 1) focus on how not to lose money & 2) continuos reasonable compounded return on corpus. We should be obsessed with not losing the money. With respect to return, one must acknowledge the power of compounding in the long run rather than one & off superlative return from the stock market. A steady annulaised return of 25% for a continuos period of five years is much better than having 40% return on first year, negative return of 5% in second & third year, 50% return in 4th year and 50% return in 5th year.

- **While buying stocks, investors should consider as buying piece of business**. This "feel of the ownership" changes the outlook of the investor and they can stay invested in the company for a long-term inspite of the occasional fall in the sales & profitability. As Mr. Warren Buffet once points out "…*in fact, we purchased several companies whose earnings will almost certainly decline this year from peaks they reached in 1999 or 2000. The declines makes no difference to us, given that we expect all our businesses to now & then have ups and downs (only in the sales presentations of investment banks do earnings move forever upward)* ". Value investors do not get deterred with gyrations of the stock indices. A value investor will take these gyrations as the opportunity to acquire the value / enact the value. Now what should be a good business? A good business is a business, which is easy to understand and run by competent professionals. These businesses have shown consistent earning power. Glamorous, hi-tech business should be avoided as these business are difficult to understand and subject to constant changes in technology (I do hope investors have not yet forget the dot-com and biotech stock bubble). Whether the business is being run by successful professional is difficult to fathom for the ordinary investors, a close glance at the management discussions of the business in the annual reports may throw some interesting insights. An honest management will accept the mistakes and won't paint rosy pictures. They will try to explain the business scenario and how they are coping to meet the challenge and exceed the expectation of the investor community.

- **Investment decision should be taken on the basis of balance sheet and not merely on the profit & loss statement**. In most of the investment advises, focus is on profitability, margin, EBITDA, EPS and P/E ratio. Very few investments advise cover the analysis of balance sheet and cash flow. Return on capital employed (ROCE) and return on net worth/equity (RONW/ROE) are the only two ratios, which an investor should look into as these separate men from the boys. We are not undermining EBITDA / net profit but these should be seen in light of cash flow from the operation and capex figure. A business, which is not generating enough cash flow from the operation, should be avoided inspite of the fact that the business has reported substantial increase in the EBITDA and net profit. In this case the cash flow is blocked in debtors and inventories or may be reduction in the credit available from the creditors. This has happened as the company has dumped its products to the dealers/distributors with a promise of extended credit. This is a worrying sign as the company is facing intense competition but they can not get enough credit from the suppliers (I,e, credit from the supplier gets reduced). Another scenario would be that a company is generating cash flow from its operation but the entire amount is being spent on capital expenditure (capex). These types of companies are also to be avoided, as there would be nothing left for the shareholders. Some exception may be there for some companies, which may be at the starting stage of their business and needs capex. As a value investor, one should only invest in a company, which generates good amounts of cash from its operation, and have minimal working capital and negligible capex requirement.

- In many research reports, Management discussions, we have observed emphasis on EBITDA. While it is true that EBITDA is a good reflector of business health but we misses out three very important things. One is depreciation, second is capex and third is blockage in working capital. While depreciation is found out in the profit and loss account of the companies but for capital expenditure & blockage in working capital, one has to refer to cash-flow. **Many people think that depreciation is a "non-cash expense", while there is no doubt of its correctness prima facie but one need to dig little further to understand the importance of depreciation**. In this respect what Warren Buffet has said, I think is apt & appropriate : *" depreciation is a particularly unattractive expense because the cash outlay it represents is paid up-front, before the asset acquired has delivered any benefits to the business. Imagine, if you will, that at the beginning of this year a company paid all its employees for the next ten years of their service (in the way they would lay out cash for a fixed asset to be useful for ten years). In the following nine years, compensation would be a "non-cash" expense – a reduction of a prepaid compensation asset establishes this year. Would anyone care to argue that the recording of the expense in years two through ten would be simply a bookkeeping formality?* ". A Company with increasing trend in EBITDA may not be a good investment if its capex and blockage in working capital takes away almost all of its EBITDA. One should be comfortable with the companies, which are having negligible capital expenditure requirement and minimal working capital blockage.

- Dividend / stock buy-back may be boring and insignificant to some investors but for a value-investor it is significant and it ensures that excess cash being returned to the shareholders. Buy-back has another advantage in the sense that investor will hold larger share of the business (assuming that he/she is not tendering its stock in the buy-back). Companies with a declared dividend policy should be a good bet.

- A company having zero debt or marginal debt is always a good investment bet as they will be able to withstand competitive pressure on their business upto a certain point. Debt is not bad either. For a utility company like power, water supply ones, where cash flow is steady, debt often boosts earning for the shareholders. But from a safe investment point of view, companies with zero or marginal debts are preferred due to its inherent strength in withstanding competitive pressures. Another reason could be that if the company decided to expand in order to tap the growing demand, it may access cheaper finance due to its "zero/marginal debt" status and the shareholders would be benefited in the long run (subject to successful expansion). To elaborate further, Like alcohol, debt can make the good times better and the bad times worse. By this, money managers mean that debt is a relatively cheap form of finance that helps companies really gear up return on equity - as long as things go well. Debt financing is good for shareholders because it does not dilute earnings the way issuing new stock does. If used well, debt boosts earnings, and at the same time it allows companies to avoid increasing the number of shares among which profits must be split. Debt, in other words, makes the good times better. On the downside, when things go poorly, a company with a lot of debt might have trouble meeting interest payments and go bankrupt. Debt makes the bad times worse. This is a problem that equity financing does not cause. Too much debt can put another constraint on a stock price. Once a firm has borrowed a lot, investors know there is no more room to use leverage to boost growth. This reduces the valuation investors are willing to assign the shares. The cut-off point varies by industry, but when debt starts to exceed equity, investors begin to get nervous. Companies whose debt is only a small fraction of their capital still have a lot of room left to use debt to fuel growth.

- "**Cash in the balancesheet**" is often an easy and safe investment criteria. For example, suppose a company is quoting at 15 Rs and it has cash @ 5 Rs/share in the balancesheet (and having zero debt) then it can be said that investor's risk is upto an extent of 10 Rs/share as each share is carrying 5 Rs cash and the balance business is available at 10 Rs /share. When the gap between market price of the share and cash/share in the balance-sheet gets narrowed down it becomes an exciting and safe investment opportunity. A Company may have cash in the balance-sheet due to just completion of a successful IPO or may be due to disposal of non-core activity and these companies should be seen as exception. There are companies, which have significant "cash-hoard" in the balancesheet but not distributing the same among the shareholders (in the form of buy-back/dividend), although they do not have any plan for diversification / capex – these companies should be seen with suspect as "shareholders interest" comes last in their wish-list.

Value investing also encompasses booking profits. One should buy stocks on a medium term basis, may be with a 3-5 year time horizon. Ideally, one would like to buy good companies at good prices and hold forever. This is the investing style being followed by Mr. Warren Buffet and in a spectacular successful manner. Although I am an ardent follower of Warren buffet and his investment philosophy, I am not with him w.r.t his "long-term" investment philosophy always. There may be some companies in which the long term investment philosophy works well but in these days, where competition are intense and coming from all angles, options of long term investing are very few. Booking profit at regular intervals is equally important. Buying into a stock at right price ensures "return of money" and provides a good amount of "margin of safety". Sometimes it may happen that after selling out, price moved up further – in this situation, investor should not rued his/her decision as one should be happy with the profit booked and one should know it is not always possible to sell at the highest point. An investment decision (be it sell or buy) should not be taken on the basis of stock indices movement. It should be on the basis on individual company's strength and weakness. Too much emphasis on the status of the industry, economy need not be given, as there will be winners in each industry category under the most difficult conditions. If a stock appreciates rapidly to the point where it no longer represents excellent in absolute terms or reasonable value relative to prospective purchases, or if new information comes to light that causes us to revaluate , it may be sold quite quickly. In this respect, I can't resist the temptation of quoting Mr. Buffet from his "letter to the shareholders – 2003 ". *"…. We own pieces of excellent businesses – all of which had good gains in intrinsic value last year – but their current price, reflect their excellence. The unpleasant corollary to this conclusion is that I made a big mistake in not selling several of our large holdings during the great babble. If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I "*

Happy investing!

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