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PART A: ARTICLES/CASES

CENTRAL TENETS OF VALUE INVESTING

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As an investment paradigm, value investing refers to purchases of securities or assets for less than their worth. When we say value investing, both the words, value and investing, are significant. First, value investors do careful valuation. Second, value investors believe in investing, not trading or speculating.

Almost all value investors seem to swear by Benjamin Graham and Warren Buffett. Value aficionados regard Benjamin Graham as the intellectual father and Warren Buffett as the most pre-eminent practitioner of value investing. Hailed as the world's most successful stock market investor, Warren Buffett's track record in accumulating wealth through successful long-term investments is nonpareil. No wonder, value investors pay close attention to the actions and writings of Warren Buffett.

Central Tenets or Ideas

A careful perusal of the literature on value investing suggests that its central tenets or ideas are as follows:

- Mr. Market and Mr. Value
- Fractional ownership
- Margin of safety
- Circle of competence
- Mean reversion
- Concentrated portfolio
- Focus on absolute return
- Humility
- Bottom up approach
- Skepticism of Wall Street recommendations
- Contrary thinking
- Marathon and patience
- Composure

- Flexibility and openness
- Decisiveness
- Long-term investment orientation
- Different perspective on risk
- Simplicity
- Selling discipline

Mr. Market and Mr. Value The stock market is very exciting and misleading in the short turn, but boringly reliable and predictable in the long run. These two facets of the market may be called Mr. Market and Mr. Value.

Introduced by Benjamin Graham in his classic work *The Intelligent Investor,* Mr. Market is emotionally unstable. At times he feels euphoric and sees only positive things and at times he feels depressed and looks at only negative things. Depending on the mood of Mr. Market, stock prices rise and fall. Mr. Market constantly fascinates and provokes investors by changing his prices. He will knock at your door every trading day with his quotations and give you the option to trade with him. He will faithfully come to you every trading day, irrespective of whether you do business with him or not.

Mr. Market constantly titillates investors with a variety of gimmicks such as earnings surprises, corporate takeovers, bonus declarations, grim news about recession, announcements of technological breakthroughs, corporate scandals, and political changes.

While Mr. Market teases and attracts our attention, Mr. Value hardly appears and rarely evokes any emotions. A remarkably stolid and reliable person, Mr. Value steadily plods in the real world. As Charles Ellis put it: “He works all day and night investing, making and distributing goods and services. His job is to grind it out on the shop floor, at the warehouse and in the store, day after day, doing the real work of the economy.”

Mr. Value’s role may not be exciting, but it is extremely important. Although Mr. Market may tickle us all the time, Mr. Value prevails in the long run. As Graham said, the stock market is a voting machine in the short run but a weighing machine in the long run.

Value investors seek to exploit the discrepancy between value and price. If the price is significantly less than value, they buy. If the price exceeds value, they sell. For them, the market is there to serve them, not to instruct them.

Fractional Ownership Value investors regard securities as fractional ownership in the underlying business and not as speculative instruments. So, the value of a security reflects the value of the underlying business.

Warren Buffett has said that he is not bothered, if the stock market is closed for ten years after he purchased a stock. That is because he does not look at stocks as pieces of paper to be traded frequently. Rather, he buys them with the objective of becoming a part-owner of the entire business. Given such an approach, value investors do careful due diligence when they purchase a stock and concentrate on how well the business is progressing.

Margin of Safety Value investors buy stocks at a significant discount to their intrinsic value, implying that they look for a large ‘margin of safety.’ In theory, the intrinsic value of a stock is equal to the present value of the cash flows generated by it in future. As a practical expedient, the intrinsic value of a company may be defined as the price a company would fetch in the open market if it were sold in its entirety to a private investor.

Circle of Competence Based on their competence and the perceived opportunity set, value investors have clarity about where they’ll look for investment ideas. Instead of relying on tips or paying attention to the continual flow of news, value investors conduct in-depth, proprietary, and fundamental research.

Mean Reversion Business cycles and company performance tend to revert to the mean. Value investors understand the import of mean reversion and profit from it. They avoid the common belief that the immediate past best informs the indefinite future.

Concentrated Portfolio Truly great investment ideas are rare. Value investors patiently wait for such ideas and when they come across them, they take large positions, in line with their convictions. In other words, they make few but big bets. As a result, they often have a concentrated portfolio.

Focus on Absolute Returns Value investors don't focus on their performance relative to a benchmark. Instead, they focus on achieving satisfactory absolute performance.

Humility A common trait of value investors is humility. They admit their mistakes and learn from them. They refrain from the tendency of taking credit only for successes and attributing failures to bad luck.

Bottom Up Approach There are two broad approaches to portfolio building: top-down and bottom-up. Top down investors begin by looking at the macro-economic environment and market trends. Then they identify sectors or industries that are expected to do well. And, finally they choose individual stocks that fit into these themes.

By contrast, bottom up investors (and value investors are typically bottom up investors) pay little heed to macroeconomic and sectoral analysis. Instead, they assess individual stocks, one at a time, on the basis of fundamental analysis. They do not try to time the market, but sift the financial markets to identify undervalued securities and then buy them regardless of the level or recent trends of the market or economy. It they cannot find bargains, they hold cash by default.

Skepticism of Wall Street Recommendations Value investors are wary of the recommendations of Wall Street analysts because of potential conflict of interest. As Jean–Marie Eveillard, a highly respected international value investor, says: "We look at outside research, but we don't trust anybody. There is a conflict of interest associated with investment banking and research. Most of the research is done for growth investors who are looking for securities to move into today and out of in six or nine months."

Value investors, of course, look at research reports to deepen their understanding of a company's working. As Ron Muhlekamp, a value investor, comments: "(The research) certainly can be useful, but I never ask an analyst what stock to buy. I want an analyst to tell me what's going on in the industry and what's going on in the company." He adds: "Their job is to know their companies. My job is to figure out what the values are and what companies I want to own."

Contrary Thinking Investors tend to have a herd mentality and follow the crowd. Two factors explain this behaviour. First, there is a natural desire on the part of human beings to be part of a group. Second, in a complex field like investment, most people do not have enough confidence in their own judgment. This impels them to substitute others' opinion for their own. As Keynes incisively observed: "Investors may be quite willing to take the risk of being wrong in the company of others, while being much more reluctant to take the risk of being right alone."

Following the crowd behaviour, however, often produces poor investment results. Why? If everyone fancies a certain share, it soon becomes overpriced. Thanks to bandwagon psychology, it is likely to remain bullish for a period longer than what is rationally justifiable. However, this cannot persist indefinitely because sooner or later the market corrects itself. And when that happens the market price falls, sometimes very abruptly and sharply causing widespread losses.

Given the risk of imitating others and joining the crowd, you must cultivate the habit of contrary thinking. This may be difficult to do because it is so tempting and convenient to fall in line with others. Perhaps the best way to resist such a tendency is to recognise that investment requires a different mode of thinking than what is appropriate to everyday living. As James Gipson said: "Being a joiner is fine when it comes to team sports, fashionable clothes, and trendy restaurants. When it comes to investing, however, the investor must remain aloof and suppress social tendencies. When it comes to making money and keeping it, the majority is always wrong."

The suggestion to cultivate 'contrary thinking' should not, of course, be literally interpreted to mean that you should always go against the prevailing market sentiment. If you do so, you will miss many opportunities presented by the market swings. A more sensible interpretation of the contrarian philosophy is this: go with the market during incipient and intermediate phases of bullishness and bearishness but go against the market when it moves towards the extremes.

Here are some suggestions to cultivate the contrary approach to investment:

- Avoid stocks which have a very high relative price-earnings ratio. A very high relative price-earnings ratio reflects that the stock is very popular with investors.
- Recognise that in the world of investment, many people have the temptation to play the wrong game.
- Sell to the optimists and buy from the pessimists. While the former hope that the future will be marvellous, the latter fear that it will be awful. Reality often lies somewhere in between. So it is a good investment policy to bet against the two extremes.

Counterintuitive Trading

Successful investors usually trade in a counterintuitive manner: they increase turnover when they are doing well, but patiently endure disappointments. This behaviour is at variance with human nature and the culture of most investment committees. If investments have fared well, it is human nature to complacently adhere to the strategy that has served well. Yet, investments that have performed well in the recent past, may no longer be attractively priced to generate good returns. Conversely, if investments have performed badly, human instincts prompt us to fix the problem by changing the portfolio. Yet, the portfolio may now be attractively priced to generate better returns.

More specifically, remember the following rules which are helpful in implementing the contrary approach:

- Discipline your buying and selling by specifying the target prices at which you will buy and sell. Don’t try overzealously to buy when the market is at its nadir or sell when the market at its peak (these can often be known only with the wisdom of hindsight). Remember the advice of Baron Rothschild when he said that he would leave the 20 per cent gains at the top as well as at the bottom for others as his interest was only on the 60 per cent profit in the middle.
- Never look back after a sale or purchase to ask whether you should have waited. It is pointless to wonder whether you could have bought a share for Rs. 10 less or sold it for Rs. 20 more. What is important is that you buy at a price which will ensure profit and sell at a price where you realise your expected profit.

Marathon and Patience Value investors consider stock investing to be a marathon, not a 400-meter sprint. In this marathon, winners and losers are determined over periods of several years, not months. As a virtue, patience is strangely distributed among investors. Young investors, with all the time in the world to reap the benefits of patient and diligent investing, seem to be the most impatient. They look for instantaneous results and often check prices on a daily basis. Old investors, on the other hand, display a high degree of patience even though they have little chance of enjoying the fruits of patience.

Whatever may be the temperamental basis for the young to be impatient, in the field of investment there are compelling reasons for cultivating patience. The game of investment requires patience and diligence. In the short run, the factor of luck may be important because of randomness in stock price behaviour, which may be likened to the Brownian motion in physics. In the long run, however, investor performance depends mainly on patience and diligence, because the random movements tend to even out.

Instead of paying constant attention to the company’s stock price, value investors focus on the progress of the business, which will lead to increased returns in long run. As Bret Stanley, a successful value investor, notes: “We’re not trying to find companies that are going to go up in the next six months.” He adds: “We’re truly adopting long-term horizon. We think about whether it’s a business we want to be involved in, and whether there's a big gap between perception and reality that's causing a disconnect between price and value."

As Warren Buffett puts it: "I should emphasise that we do not measure the progress of our investment by what their market prices do during any given year. Rather we evaluate their performance by two methods we apply to the businesses we own. The first test is improvement in earnings with our making due allowance for industry conditions. The second test, more subjective, is whether their moats—a metaphor for the superiorities they possess that makes life difficult for their competitors—have widened during the year."

Composure Rudyard Kipling believed that an important virtue for becoming a mature adult is to keep your head when all around you are losing theirs and blaming it on you. The ability to maintain composure is also a virtue required to be a successful investor. Conscious of this, as an investor you should try to (a) understand your own impulses and instincts towards greed and fear; (b) surmount these emotions that can warp your judgment; and (c) capitalise on the greed and fear of other investors.

While the above advice sounds simple, it is difficult to practise. Greed and fear are far more powerful forces than reason in influencing investment decisions. Rarely do you come across an investor who is immune to these emotions that are so pervasive in the market place. Greed and fear tend to be insidiously contagious. In your attempt to overcome them, you may find the following suggestions helpful.

- Maintain a certain distance from the market place. Your vulnerability to the contagious influences of greed and fear diminishes, if your contact with others caught in the whirlpool of market psychology decreases.
- Rely more on hard numbers and less on judgment (which is more prone to be influenced by the emotions of greed and fear). This is the advice given by Graham, widely regarded as the father of security analysis.

Flexibility and Openness Nothing is more certain than change in the world of investments. Macroeconomic conditions change, new technologies and industries emerge, consumer tastes and preferences shift, investment habits alter, and so on. All these developments have a bearing on industry and company prospects on the one hand and investor expectations on the other.

Despite the inexorability of change, most of us adjust to it poorly. We often base our expectations assuming that the status quo will continue. As J.M. Keynes said: "The facts of the existing situation enter, in a sense disproportionately into the formation of our long-term expectations; our usual practice being to take the existing situation and project it into a future modified only to the extent that we have more or less definite reasons for expecting a change."

We tend to compound the problem further by being over-protective of our judgment, mainly due to psychological reasons. This leads to a failure to absorb and interpret new information with an open mind. This inability to consider new evidence blinds us to the flaws in our operating premises. As Arthur Zeikel said: "We tend to develop a 'defensive' interpretation of new developments, and this cripples our capacity to make good judgments about the future."

Since an open mind, not blocked by prejudices and biases, is crucial for success in investing, conscious and deliberate efforts should be made to re-examine old premises, assimilate new information, and cultivate mental flexibility. Barton M. Briggs put it this way: "Flexibility of thinking and willingness to change is required for the successful investor. In the stock market, in investing, there is nothing permanent except change. The investment manager should try to cultivate a mix of healthy skepticism, open-mindedness, and willingness to listen."

Decisiveness An investor often has to act in face of imperfect information and ambiguous signals. Investment decisions generally call for reaching conclusions on the basis of inadequate premises. To succeed in the investment game, the investor should be decisive. If he procrastinates, he may miss valuable opportunities; if he dillydallies, he may have to forego gains.

Decisiveness does not mean rashness. Rather, it refers to an ability to quickly weigh and balance a variety of factors (some well understood and some not-so-well understood), form a basic judgment, and act promptly. It reflects the ability to take decisions, after doing the necessary homework of course, without being overwhelmed by uncertainties characterising the investment situation. The most successful investors tend to be those who are willing to make bold positions consistent with their convictions. Vacillation and half-hearted commitments often produce lacklustre investment results.

Different View of Risk When financial academics refer to risk, they almost always mean only *market risk* and that too very short-run market risk. For value investors, such risk is of little concern. What matters most to them is *investment risk*—the possibility that something could go wrong with the company or securities covenants. Value investors think about risk as the probability and amount of potential loss. So, they find beta, a measure of historical volatility, to be meaningless. In fact, a volatile stock may become deeply undervalued, making it a very low risk investment.

Simplicity A shared characteristic of eminent value investors is simplicity, which is a powerful construct. As Thoreau said, "Our life is frittered away by detail… simplify, simplify." Einstein recognised that simplicity was the key to his breakthroughs is physics. The genius behind$E = mC2$ embodied simplicity and elegance. Einstein noted that the five ascending levels of intellect were, "Smart, Intelligent, Brilliant, Genius, Simple." Likewise, the hallmark of Buffett's style is simplicity. Indeed, thinkers like Einstein and Buffett, who exemplify simplicity, achieve great heights.

Selling Discipline The decision to sell a stock is often harder to make than the decision to buy. Value investors try to achieve selling discipline by laying out well defined criteria for determining when to sell. As James Gipson, a value investor, said: "We will sell a stock when it reaches intrinsic value. It can reach intrinsic value in two ways. Either the price can go up, or the value can go down." Another reason value investors may sell is when they find something more attractive.

PART B: SNIPPETS

1. SEVEN SINS OF FUND MANAGEMENT

According to James Montier, fund managers commit seven sins.

Sin 1: Forecasting (Pride)

Sin 2: The Illusion of Knowledge (Gluttony)

Sin 3: Meeting Companies (Gluttony)

Sin 4: Thinking You Can Outsmart Everyone Else (Envy)

Sin 5: Short Time Horizons and Overtrading (Avarice)

Sin 6: Believing Everything You Read (Sloth)

Sin 7: Group- Based Decisions (Wrath)

2. WHAT STOPS INVESTORS FROM BEING VALUE INVESTORS

1. Knowledge is not the same thing as behaviour.
2. Loss aversion
3. Hard wiring for the short term
4. Herding habit
5. Poor stories
6. Overconfidence
7. Fun
8. No, honestly I will be good

3. DETERMINANTS OF HAPPINESS

Research suggests that there are three determinants of happiness: a genetically determined set point, circumstances, and intentional activities.

The biggest contributor to happiness is the genetically determined set point (or, more accurately, set range). This means that people are predisposed to a certain level of happiness which is based on their genetic endowment. As Sheldon et al. observed: "The set point likely reflects immutable interpersonal, temperamental and affective personality traits, such as extraversion, arousability, and negative affectivity, that are rooted in neurobiology, … are highly heritable…. and change little over the lifespan."

As Adam Smith noted in his book *Theory of Moral Sentiments*, written in the 18th century:

> "The mind of every man, in a longer or shorter time, returns to its natural and usual state of tranquillity. In prosperity, after a certain time, it falls back to that state; in adversity, after a certain time, it rises up to it."

Current research on the psychology of happiness suggests that the genetically determined set range accounts for around 50% of an individual's happiness.

The second component of happiness is circumstances which includes factors like marital status, income, job security, occupation, health, and religious affiliation. Surprisingly, life circumstances contribute a mere 10% to happiness. Hedonic adaption severely limits the ability of changes in life circumstances to improve long- run happiness.

Since the set point is genetically determined and changes in life circumstances have a small impact, the scope for increasing happiness on a long- term basis lies mostly with the third and final component of happiness, viz intentional activity which accounts for nearly 40 percent of people's happiness. Intentional activity is defined by Sheldon et.al as "discrete actions or practices that people can choose to do."

Intentional activity can be roughly broken down into three areas:

- *Behavioural activities* such as exercising regularly, having sex, being kind to others, and socialising.
- *Cognitive activities* such as trying to see the best, expressing gratitude, and counting how lucky one actually is.
- *Volitional activities* such as devoting effort to meaningful causes and striving for personal goals.

Unlike changing life circumstances, intentional activity is less vulnerable to hedonic adaptation. As James Montier put it, "The very nature of activities means they are episodic, and hence are unlikely to become part of the 'norm' in the way alterations to circumstances do. Because activities are not permanent they can be varied, which again helps to prevent hedonic adaptation."

PART C: WIT AND WISDOM

1. HUMOUR

- Mrs Brown (very annoyed), "Look Mrs. Green, Mrs. White told me you told her the secret I told you not to tell her."
  Mrs Green, "Oh that mean Mrs. White. I told her not to tell you what I told her."
  Mrs. Brown, "Look here. Don't tell her I told you what she told me."
- When an actor proposed to his girlfriend, she replied, "I do love you and want to marry you. But I am scared that you've been married five times before." "Darling!" pacified the actor, "Why listen to a lot of old wives' tales?"

2. WISE SAWS

- With money in your pocket, you are wise and handsome and you sing well, too. Yiddish proverb.
- The more a man knows, the more he forgives. Catherine the Great.