BRANDES INVESTMENT PARTNERS
COMMEMORATING 35 YEARS

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Value Investing

A Brief History

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In 1934's *Security Analysis,* Benjamin Graham urged investors to search for opportunities among out-of-favor stocks. The fundamental thesis underlying the approach was that, in the short term, investor irrationality sometimes pushes prices for these stocks well below their true long-term values. By purchasing select out-of-favor stocks, Graham believed shrewd investors could benefit from the broader market's impulses and mistakes.

Seven decades later, the philosophy espoused by Graham is widely known as value investing, and the track records of some of the world's successful investors point to the power of its principles. In this issue of The FOCUS, we take a closer look at the approach that guides our firm's investment activities. Topics we review include the origins of value investing, its main philosophical underpinnings, and its historical performance record.

VALUE INVESTING: A BRIEF HISTORY

Ben Graham, widely considered the father of value investing, knew little about Wall Street when he reported to work after graduating from Columbia University in 1914. By the late 1920s, however, Graham had earned distinction as an astute investor and had founded the Graham Newman Co., a money management firm he would guide skillfully for 30 years.

Concurrent with his career on Wall Street, Graham taught a weekly course on investing at Columbia University. David Dodd, an assistant professor of finance, was enlisted to take notes at Graham's lectures, and these notes led to the publication of *Security Analysis,* a 700-page tome that described Graham's investment methods in detail. Today, *Security Analysis* – often referred to as the value investor's bible – stands as the longest running investment text ever published. *The Intelligent Investor,* a slimmer volume Graham wrote for the non-professional investor in 1949, also remains widely available.

Graham retired in 1956, after introducing the world to the value philosophy and directly influencing future investing standouts such as Walter Schloss, Tom Knapp, and Bill Ruane. Of course, Graham's most famous disciple is Warren Buffett, who studied under Graham at Columbia and subsequently worked for him at Graham Newman Co. To this day, Buffett remains committed to value investing's ideals: "Follow Graham," Buffett writes, "and you will profit from folly rather than participate in it." [i]

VALUE INVESTING: KEY PRINCIPLES

So what is value investing all about? To answer this question, let's start by examining two concepts that are central to the value philosophy: the importance of a business owner's perspective, and the irrationality of the stock market in the short term. From there, we'll explore other key principles, including intrinsic value and the margin of safety.

A Business Owner's Perspective

To understand the importance of a business owner's perspective, one must first recall that a stock is simply an ownership slice of the company that issued it. If XYZ Inc. has issued 100 shares of stock, for example, each one represents 1/100th of XYZ's ownership. Accordingly, an investor contemplating a purchase of one XYZ share is effectively pondering a purchase of 1/100th of the entire firm.

How does the investor decide if the XYZ share is a good buy? For value investors, the first step is to adopt the perspective of a business owner evaluating the worth of the entire XYZ business. This means passing on complicated, top-down forecasting and market timing. Instead, value investors ask questions a business owner would be concerned with – How much income does XYZ generate? Is the firm on solid financial footing? – and use the answers to estimate the company's "intrinsic value," or its inherent worth. Then, in this hypothetical case, this value is divided by 100 (the number of shares of the company) to arrive at an estimate of intrinsic value per share.

We'll explore intrinsic value in more detail later. For now, remember that value investors see themselves as business

owners when evaluating a stock's appeal. This level-headed approach is important because – as we'll discuss next – value investors believe the stock market can be anything but level-headed, at least in the short term.

The Short-Term Irrationality of the Market

A key teaching from Ben Graham is that, in the short term, the stock market is a voting machine, with a stock's price reflecting the stock's popularity with investors on any given day. In the long term, however, the market is more of a weighing machine, aligning a stock's price to reflect the value of the underlying business.

For value investors, this means that a stock's price and its fair value often detach from one another in the short term. Because of the manic-depressive nature of the overall market – where sentiment can shift between sweeping, carefree optimism and overwhelming fear and uncertainty seemingly overnight – prices of stocks tend to fluctuate much more than the intrinsic value of the companies they represent. This irrationality can materialize on the upside, lifting prices to dangerously lofty heights. It also can appear on the downside, dragging prices for select stocks to bargain levels.

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Value investors target the latter situation, purchasing out-of-favor stocks that are trading at discounts to their fair values, and then holding these stocks until the market recognizes their inherent worth. By confidently approaching the short-term vagaries of the market with rational, objective analysis, we aim to identify compelling investment opportunities and deliver superior long-term results. As Graham puts it in *The Intelligent Investor,* "the stock market often goes far wrong, and sometimes an alert and courageous investor can take advantage of its patent errors."[ii]

Value investors believe that, as the broader market recognizes the inherent worth of an undervalued company, its share price will climb toward its intrinsic value. Of course, this process often takes time – and, once purchased, a stock's price may even decline further in the short term. With this in mind, we exercise patience and manage our holdings from a long-term perspective. Typically, we expect to hold a stock for as long as three to five years, or until the company's stock price climbs to our estimate of its intrinsic value.

Calculating Intrinsic Value

We've noted that value investors believe market irrationality can influence a stock's market price dramatically – and can sometimes give rise to wide discrepancies between price and true, intrinsic value. But what is intrinsic value, exactly? And how is it calculated in practice?

To answer the first question, we'll share a definition provided by Warren Buffett in "An Owners Manual," a 1996 publication to shareholders of Berkshire Hathaway. "Intrinsic value can be defined simply," Buffett wrote. "It is the discounted value of the cash that can be taken out of a business during its remaining life." In other words, a company's intrinsic value is equal to the value today of all the money it will deliver in the future.

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So how is intrinsic value calculated? Admittedly, the process is not a precise science. In fact, instead of striving for an exact figure, value investors often focus more on estimating a company's intrinsic value within a workable range. To do this, we emphasize an approach based on thorough research and analysis of current and historical fundamental company information.

From there, value investors typically calculate intrinsic value by focusing on earnings, cash flow, and other indicators of the company's wealth-creation potential. Alternatively, an intrinsic value estimate is sometimes calculated based on an analysis of the value of the company's assets less its liabilities.

Importantly, value investors don't expect to be able to come up with intrinsic value estimates for every stock in

the market. Firms operating in nascent, rapidly changing industries, for example, are often surrounded by levels of uncertainty that make any estimates of underlying worth dubious. In cases like these, value investors recognize the limits of their abilities and move on to evaluate other companies.

The Margin of Safety

In *The Intelligent Investor*, Ben Graham challenged himself to "distill the secret of sound investment into three words." The three words Graham chose were "margin of safety." What does this phrase mean?

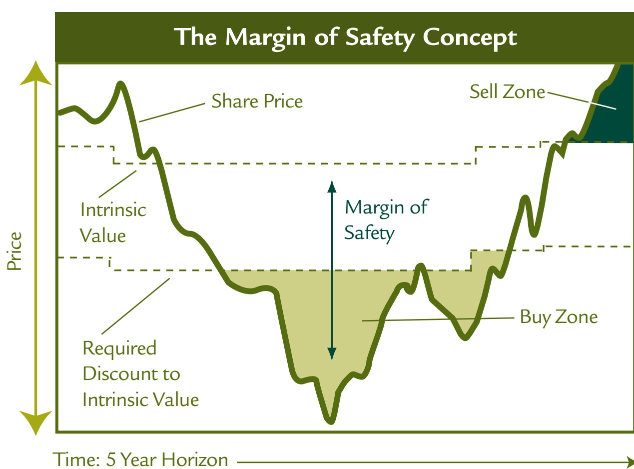


Illustration (assumes intrinsic value changes over time). See disclosure page.

Simply put, the margin of safety represents the difference between a company's stock price and its estimated intrinsic value. Value investors believe that the larger this margin, the safer the investment. By scooping up stocks trading at discounts to their estimated intrinsic values, we aim to build portfolios that generally can accommodate future uncertainty and demonstrate resilience in market downturns. Some holdings will inevitably encounter the occasional stumbling block, and a margin of safety may provide protection if the going gets tough.

One More Trademark: Independence

An additional quality at the heart of the value philosophy is independence – the willingness to think differently. As believers in the opportunity inherent in out-of-favor stocks, we don't follow the investment crowd. Instead, we search for overlooked opportunities that the crowd has passed by. It's not always easy, but we believe that confidence in our research and courage in our convictions enable us to profit from this against-the-grain style.

VALUE INVESTING: HISTORICAL PERFORMANCE

So far, we've explored the origin of the value philosophy and examined its key principles. In this section, we look at value investing's historical results.

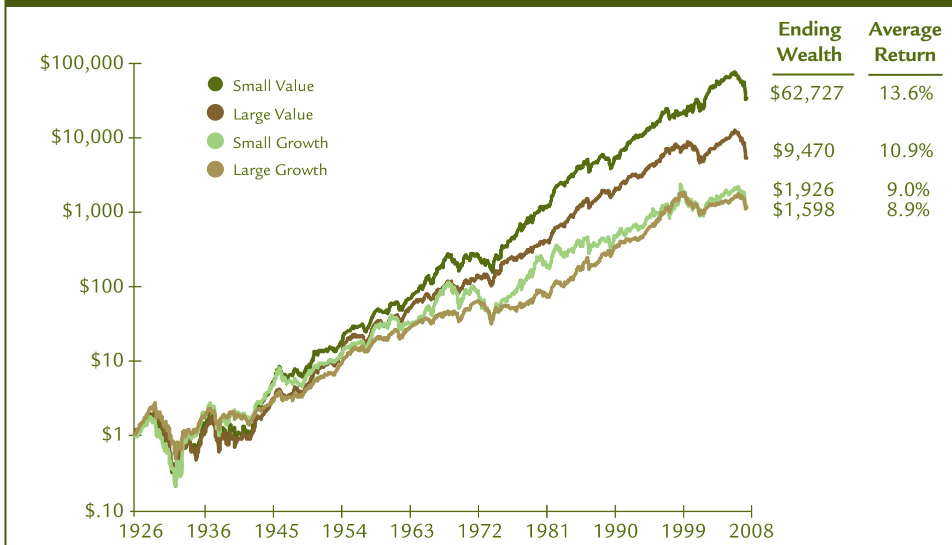
Some investors think the value approach is a defensive tactic, a strategy used to weather bear markets, a style that can protect against steep losses – but won't provide much in terms of long-term gains. However, historical returns for value investing often have been exceptional – and have been achieved with limited volatility.

On his website, finance professor Kenneth French of Dartmouth's Tuck School of Business compiles historical value-versus-growth stock returns. French uses price-to-book ratios to separate value from growth stocks. Market capitalizations for small- and large-cap stocks are based on the median market capitalization of those stocks traded on the NYSE (e.g. the largest 50% represents large cap, while the smallest 50% represents small cap), and portfolios are rebalanced quarterly. Analysis of the data on his website, for the 82-year period ended December 31, 2008 yields the following results:

December 31, 1926 – December 31, 2008			
	Annualized Return	Annualized Standard Deviation	Worst 12-Month loss
Small Value	13.61%	29.03%	-70.30%
Small Growth	8.95%	27.10%	-65.97%
Large Value	10.91%	25.48%	-75.01%
Large Growth	8.87%	18.72%	-62.78%

Source: mba.tuck.dartmouth.edu/pages/faculty/ken.french and Brandes Investment Partners as of 12/31/08 (dividends and capital gains are assumed reinvested)

Growth and Value Investing – December 31, 1926 - December 31, 2008



Source: mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Research and Brandes Investment Partners as of 12/31/08. Hypothetical value of $1 invested at year-end 1926. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. Past performance is no guarantee of future results. Actual results will vary.

French, along with the University of Chicago's Eugene Fama, has spent years studying the relative success of the value and growth strategies. The pair found that, for both small- and large-cap stocks, value stocks – or those with lower price-to-book ratios – have returned substantially more than those with higher book value multiples over the last 82 years. While data for this 82-year period demonstrates that value investors experienced periods of greater volatility (as measured by annualized standard deviation) and larger short-term price declines than growth investors, performance disparities between growth and value stocks have made substantial differences in investors' long-term wealth accumulation. For example, as the chart above indicates, the ending wealth contained in portfolios of value stocks dramatically outsized the ending wealth of growth stock portfolios during the period. One dollar invested in large- and small-cap growth stocks grew to $1,598 and $1,926, respectively. Over the same period, however, $1 invested in large- and small-cap value stocks did much better, appreciating to $9,470 for large stocks and $62,727 for small stocks. We believe this illustrates the potential benefits of a value investing approach on an investor's chief concern: the ultimate value of his or her portfolio in the long term.

IN CLOSING

In 1934's *Security Analysis*, Ben Graham outlined an investment philosophy designed to identify opportunities among out-of-favor stocks. With a focus on principles such as a business owner's perspective and a margin of safety, Graham's approach – value investing – aims to take advantage of short-term market irrationality by purchasing stocks at discounts to their estimated intrinsic values. And across several decades of market ups and downs, the value philosophy has yielded competitive long-term returns.

At Brandes Investment Partners®, value investing has served as the foundation for our investment decisions since our inception in 1974. For more information on the philosophy pioneered by Ben Graham, please contact us.

i Buffett, Warren E., Preface, *The Intelligent Investor: A Book of Practical Counsel,* 4th rev. ed., by Benjamin Graham, New York: Harper Row, 1973.

ii Graham, *The Intelligent Investor,* p. 106.

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The illustration of intrinsic value is purely hypothetical and any resemblance to any specific securities is strictly unintended. There is no guarantee or implication that any specific security will ever trade as low as the buy limit (the intrinsic value less discount) nor that it will ever trade as high as the assessed intrinsic value. Situations arise where securities, having been bought, cannot be sold at a profit. The assessed intrinsic value estimate of any security, or the discount for purchase, may be amended at any time.

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