VALUE INVESTMENT INSTITUTE

Screen or Smokescreen?

In a 2007 interview with Warren Buffett, Liz Clayman of the Fox Business Network asked:

> *"How did it come to your attention, how do you find a stock like PetroChina?"*
>
> **Buffett**: *"I sat there in my office and I read an annual report, which was fortunately in English, and it described a very good company. And it told about the oil reserves, told about the refining, told about chemicals and everything else and I sat there and read and I said to myself this company is worth about $100bn.*
>
> *Now I didn't look at the price first – I look at the business first and try and figure out what it's worth because if I look at the price first I get influenced by that.*
>
> *So I look at the company first, I try to value it and then I look at the price and if the price is way less than what I just valued it at I'm going to buy it."*

Clayman's question referred to Berkshire Hathaway's purchase of a stake in PetroChina around 2002/03. At the time of purchase, the market capitalisation of PetroChina was $20 billion, circa one-fifth of Buffett's own estimate of intrinsic value.

Less than four years later, Buffett sold Berkshire's stake for $3.5 billion, a handsome return on the roughly $500 million cost of the investment. [The more than doubling of the oil price in the meantime increased his estimate of fair value.]

However, more important than the investment outcome, I believe, is Buffett's approach to business valuation, telling us that he valued it without reference to the stock market price. I believe it is a crucial but hugely under-appreciated key to long-term investment success.

I mention this by way of introducing a recent conversation I had with an investment adviser that I know well. He was taken aback when I told him that I had stopped, since a couple of years back, using 'screens' to generate investment ideas. A brief outline of a screen, which most investment practitioners will be familiar with, would be as follows. The universe of stocks is very large (many thousands) and an investor's time is limited. A screen – specific criteria that stocks must pass for inclusion – can reduce down the universe to more interesting candidates, from which point the investor can choose to carry out further research.

Each manager will have his own preference for which screening factors best improve his chances of highlighting good potential investment candidates, therefore it is difficult to generalise about their effectiveness. Some include factors that seek out quality, such as high profit margins or returns on capital; others screen for stocks that are out of favour by focusing on share prices that have fallen a lot. However, my guess is that at the core of most screens are market valuation-based factors, such as a low price-to-earnings ratio, a low price-to-book value, a high dividend yield, or some combination thereof.

Certainly this would seem like a reasonable place to start – all else equal, one should be trying to pay as low a price per dollar of earnings (or book value etc.) as possible. In addition, this information is generally readily available for most stocks through financial software such as Bloomberg.

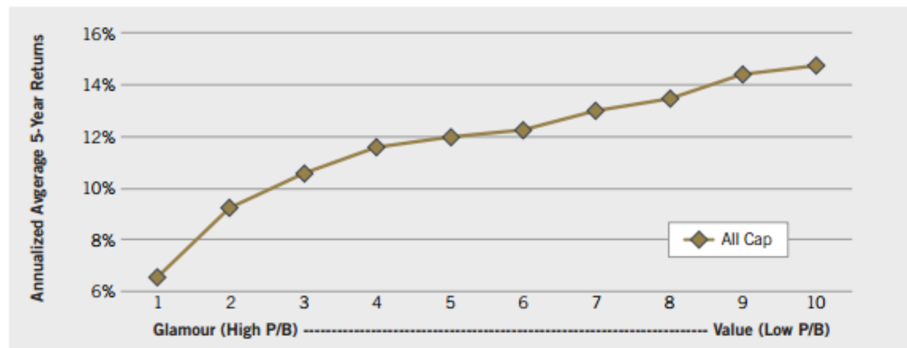
Additionally, the academic research would appear to concur. The historic data suggests that the cheapest ('value') stocks have outperformed expensive ('glamour') stocks by a wide margin. In 2009, US-based investment management company Tweedy, Browne Company LLC produced a document called *"What Has Worked In Investing, Studies of Investment Approaches and Characteristics Associated With Exceptional Returns"*, available on its website. The paper documents over 50 of the major academic studies of successful investment approaches. The Tweedy paper concludes:

"The papers by Fluck, Malkiel and Quandt, and by Lakonishok, Shliefer and Vishny, together with similar studies described in the "Assets Bought Cheap" and "Earnings Bought Cheap" sections of ***What Has Worked In Investing*** *demonstrate that, at the extreme, investors overvalue and undervalue individual stocks, and that the best returns come from buying stocks at the extreme end of the value spectrum."*

The above-mentioned 1994 Lakonishok, Shliefer and Vishny ("LSV") study, which examined US stocks in the period 1968 to 1989, is still seen as the reference study on value versus glamour investing. LSV found that a strategy that bought low-priced stocks (in relation to book value or cash flows or earnings) did far better than high-priced stocks, as well as the overall market. Moreover the results showed a tendency for improved outperformance the longer the holding period of the portfolio, up to 5 years.

The Brandes Institute periodically updates the LSV results, for US as well as international stock markets. The latest report presents the results up to June 2012 and shows that generally speaking the value premium has persisted. The chart below shows the results of the US market using price-to-book multiples, but the results are similar to results for low-P/CF and low-P/E stocks, as well as non-US markets.

Exhibit 7: Annualized Average 5-Year Returns
(P/B Deciles, April 30, 1968–April 30, 2012)



Source: Compustat via FactSet, The Brandes Institute; as of 4/30/2012. Past performance is not a guarantee of future results.
http://www.brandes.com/Institute/Documents/White%20Paper-Value%20Vs.%20Glamour%202012.pdf

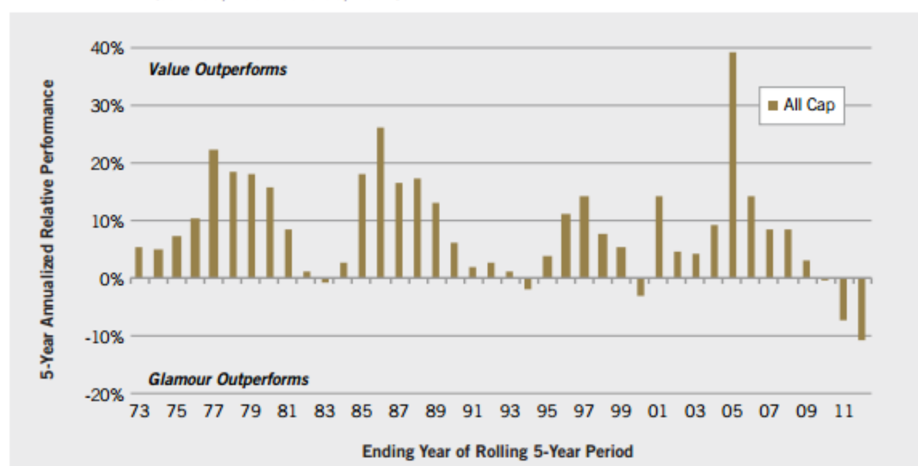
Remember, these academic studies have used very rudimentary rules that could very easily be incorporated into a valuation screen. They required limited human input and they produced stunning results.

Before you all rush off to create your own valuation-based screens, remember that while the results of the academic studies look compelling, they are backward looking. As the *Brandes* chart above says, *past performance is not a guarantee of future results*. Moreover, it could be leveled that most such studies relate to a time when computing power was less / non-existent, databases were fewer / non-existent and so screening was employed less frequently / hardly ever. Back then gathering data was manual, tedious and slow, so the advantage to the persistent few was likely significant. It's really only in the last say 15 years that the ability to screen has become cheap, easy and widespread.

Now think how similar so many valuation-based screens look – the same group of statistically cheap companies is being highlighted to thousands of analysts and fund managers. In addition, numerous quantitative funds have been set up to screen and buy screen-based value stocks. Under such conditions, the likelihood of unearthing cheap, over-looked stocks would appear to be slimmer than it used to be. It begs the question: are the remains of this picked-over carcass cheap for a reason?

As it happens, *The Brandes Institute*'s updated study shows that value stocks have recently underperformed the glamour counterparts – in a historical context, quite dramatically so. Value portfolios purchased at the end of 2005, 2006 and 2007 underperformed in the subsequent 5 years (to 2012). This is very interesting and I really don't know what to make of it – is it suggestive of a world where valuation-based screening no longer works? Or is the scene set for a very rewarding future for statistical value portfolios? It's certainly worth keeping an eye on.

United States: Rolling 5-Year Annualized Relative Performance of Value vs. Glamour
(June 30, 1980–June 30, 2012)



Source: Worldscope, The Brandes Institute; as of 6/30/2012.
Years with no performance listed on the chart may reflect that the country universe was not robust enough to provide data for 10 deciles.

Perhaps valuation-based screening still works, perhaps it doesn't. Actually, I think the answer is largely irrelevant. The real question serious investors should be asking is: does it present the best opportunity to maximise long-term returns? Is the statistical value pool the best one to fish in? I can't help but conclude that it's a vastly more crowded trade than it was perhaps as recently as 10 years ago.

In a recent interview in the investment publication *Manual of Ideas*, value investor Tom Russo spoke of his dislike for many popular Wall Street financial metrics, such as cash conversion of net income and R&D-to-sales ratio. Most company management teams are fearful of falling short of sell-side analysts' and short-term investors' expectations. At the expense of long-term value-creation, managements will, for example, avoid worthy investments that will pressure current profits because it will make their stock appear more expensive. The best companies resist these pressures and as such often won't look cheap on simple, valuation-based screens.

So, my investment adviser friend continued, I still can't see how it's possible to whittle down your opportunity set to the one or two stocks that you might buy in a year. He's married, so I retorted: how did you whittle down all the potential girls in the world and end up with your wife? The answer of course is that he didn't use anything like a screen, rather he simply searched for good characteristics in a partner and when he came to one he loved, he 'bought'. He had no way of knowing whether his choice would be the best, but he felt certain she would be an excellent long-term choice. My investment search goes something like his wife search, though I'm hopeful his 'portfolio turnover' will be far lower than mine (not least because of high 'transaction costs')!

A valuation-based screen approach is the mirror image of how Buffett approaches investing. The former approach starts with the share price. The latter starts with the investor's appraisal and only then references the share price. It's night and day.

It's quite plausible that valuation-based screening will continue to be a successful investment strategy. Perhaps no matter how much computing, database and screening power you have,

the *ick* factor means there will never be much investor interest in owning the cheapest – the *ugliest* – stocks.

However, I can't help feeling that the Buffett approach can offer richer investment rewards. Yet – and I hate to admit it – I find it extremely difficult to do months of work on a stock without ever catching a few flirtatious looks from Miss Market, batting her eyelids and whispering such sweet nothings as *"XYZ Corp – it's now on less than a market multiple"*. This undoubtedly affects my ability to independently appraise investments. I remind myself that Odysseus tied himself to his ship's mast to prevent him from being lured by the sirens of Greek mythology. Oh, but the flesh is weak….

I will re-double my resolve. I will pour beeswax into my ears, analyse and value good quality companies as a first step. Only then – and still strapped to the mast of value investing – will I allow myself to listen to the sirens' song.

The Value Investment Institute, August 2013

[With many thanks to Yusuf Samad, a UK-based value investor, who highlighted Buffett's unique investment approach at a 2011 ValueX conference. This idea has been fermenting in my mind ever since.]