ARGUCIA

CAPITAL MANAGEMENT

Value Investing

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Value Investing

The effort of the book is to build on the work of Benjamin Graham and his successors, also incorporate the advances in value investing.

"Benjamin Graham is to investing what Euclid is to geometry and what Darwin is to the study of evolution."

The New York Society of Securities Analysis

Time Line

Before 1934

World is dominated by speculation, and insider information

1934 - 1949

Publication of the “Security Analysis” and “The Intelligent Investor”.

Graham fund a scholar at Columbia University based on Rational Foundation

1960 - 1980

Modern Investment theory. It isn’t possible to perform better than the market. The best strategy is to buy the Index and adjust for the desired level of risk combined with risk free assets.

Last 20 years

A number of studies challenged the efficiency hypothesis.

Financial Markets

Characteristics:

- Prices of financial assets changes every day indicating an opportunity to buy or sell.

*** Attention: long state period.

- Value is different than price, they may converge or not.

- Buy securities when the value is bellow the market price.

Analysts

Three basic kinds:

- Technician Analyst:
  - Focus in trading data (price and volume movements). They believe the history of these movements will follow the same path in the future.
- Macro Fundamentalist:
  - Try to forecast economy trends. Their approach is referred as **top down**
- Micro Fundamentalist:
  - Takes to price of a stock as the point of departure. They study the earnings of the company, products, industry… **bottom up**

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Valuation

Essential task is to estimate value with accuracy.

- Discounted cash flow analysis
- Stream of Earnings over years
- Profitable Growth with competitive advantage

Attention: When we use discounted cash flow, 0,1pp in the rate makes a big difference. One way to deal with the uncertainties is to make an exhaustive number of analyses operating the parameters.

Danger: Estimating Values in long future we have to make assumptions and preview the long future.

Suggestions:

⟶ Use knowledge to reduce uncertainty

⟶ Don't mix good information with bad information

Net-Net Approach

Benjamin Graham favorite tool

Net-Net:

Current assets minus all the liabilities.

Attention:

- Values in balance sheet are more accuracy than others
- Farther down the balance sheet is harder to make an accurate estimative of value.

Earning Power Value

When using the EPV we need to assume with present, future earnings and cost of capital.

EPV=Adjusted Earning / Cost of Capital

**Uncontaminated by uncertain conjectures*

Example: The company "Waneça" earned 50MM in 2006, if the value of the assets in this year was 200MM and cost of capital was 12% indicates that:

EPV= 50/,12 = 416

Margin for new competitor = 416MM – 200MM = 216MM

Competitive Advantage

Competitive advantages are equivalent to **barriers of entry** against competitors.

- Government Regulation
- Patents
- Economy of Scale
- High Switching Cost
- R&D and MKT
- Cheaper access of capital
- ...

ps: To make some projection we have to assume that the franchise is durable and the spread between cost of capital and return on capital will persist

Example of a company with franchise WD-40

- What is the strategic position?
- Is there any difference between other lubricants?
- Where are the competitors if EPV more than 3 times?
- Why Consumers are willing to pay more than it costs?

→ 10% of the sales expend in advertising

→ Rich channels of distribution

→ Economies of scale

The Power of Growth

- We need to understand that growth doesn’t mean very much at all.
- For most companies in a competitive market, all the value of growth will be consumed to pay for additional capital that is necessary to fund the growth.
- Companies that produces gains above-normal return are those who operate protected by barriers of entry.

Ex: If the company returns on capital is about 12% the cost of growth should be lower than 12%

Reviewing (Graham and Dodd Framework)

Value of Growth

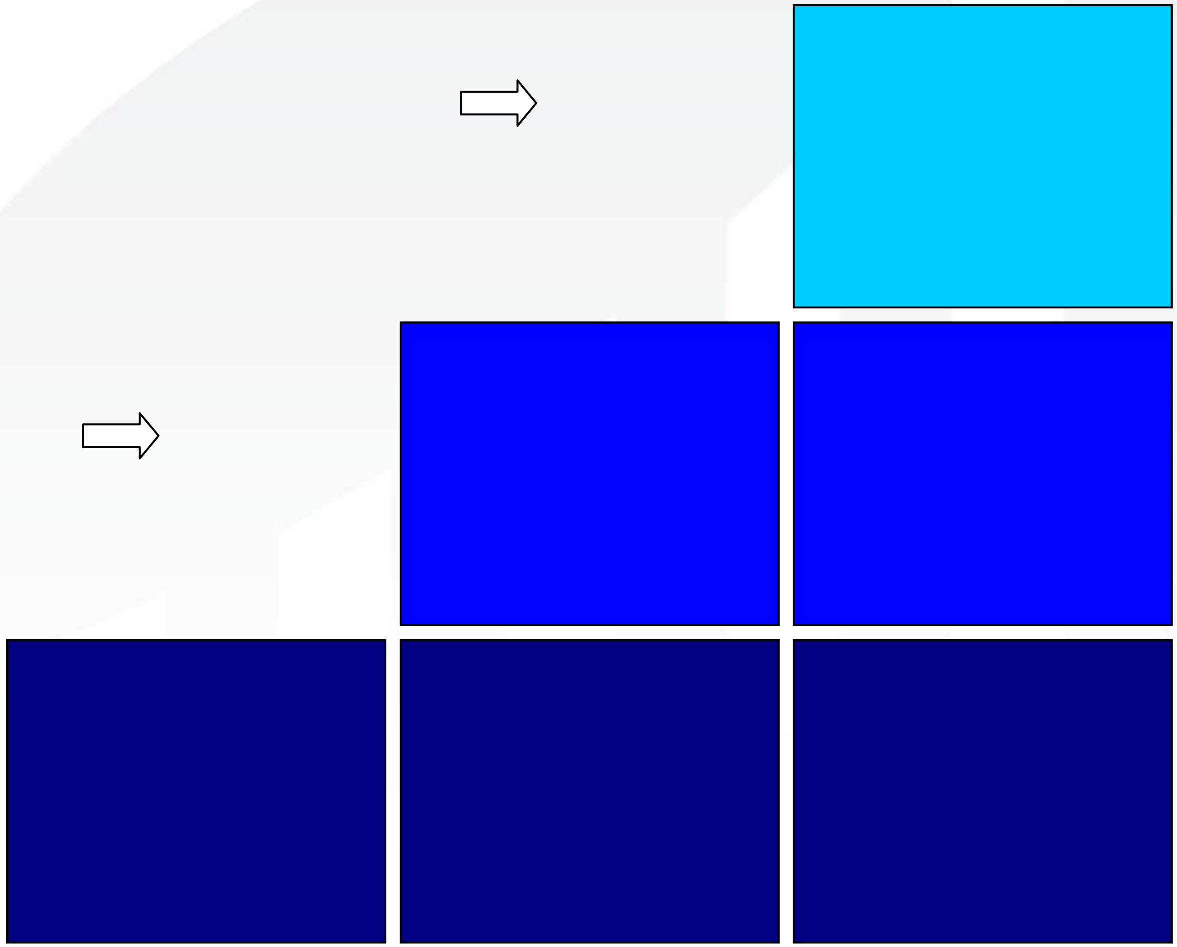
- Only if growth is with competitive advantage

EPV

- Franchise Value

Asset Value

- Free Entry
- No competitive advantage



Risk

- What's your definition of Risk?

  Buffet defines risk as the dictionary does: *"The possibility of loss or injury"* Value Investors do not accept the idea of risk as just relative volatility. Buying a company for substantially less than the book value is already a low risk strategy.

  "It's better to be approximately right than precisely wrong"

  Warren Buffet

  This is Buffet reference to statistics and academics who use beta (volatility in the past) and attribute the risk to the historic.

  "A stock who has dropped compared to the market will be more risky with low price?"

  Warren Buffet

Diversified Portfolio

- Systematic X Nonsystematic risk
- Find assets whose returns are not strongly correlated with one another.
- Limiting position to a stock
- Limiting position by sectors

But this not all value investors think like this...

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Glenn Greenberg

"Put all your eggs in one basket and - what the basket!!!"

- Don't begin to buy until they are willing to pay at leas 5% of their assets
- Understand the company, the industry and the business. Be an expert in the company.
- Go to companies' meeting and talk to the management regularly

"If diversification is a substitute for knowledge, then information and understanding should work in reverse".

"If there are only few eggs in the basket, they had better be the right ones."

Warren Buffet

Principles

- Buy business not stocks
- Look for companies with big franchises
- Look at the ownership the same way as a business man does

Want to buy business that:

- We understand
- Has long term prospects
- Operated by honest and competent people
- Available in a very attractive price

Mario Gabelli

- $20 billion under management

- Graham did not have much company looking for stocks using the net-net approach.

- PMV (Private Market Value)
  - Try to capture the premium of control
  - **Catalyst:** an event, a person, a change in perception
    - Specific (sale of a company)
    - Environmental (Global Warming, Berlin Wall)

Seth Klarman

- Two rules:
  - *"Don't lose money!"*
  - *"Don't forget the first rule!"*
- Motivated sellers: sell for a non economic reason. Ex: S&P500
- Missing Buyers: hard to sell stock
- Catalysts Independent of the Market: dividends

He worry about the risk before he begins to think about the potential return: most **people feel more intensely about the losses** they may incur than about the gains they may earn.

Walter and Edwin Schloss

When to Buy, When to Sell

- No one can predict tops, bottoms, or anything between.
- Don’t buy/sell too much in the initial purchase.
- Be confidential:
  - Warren Buffet difficulty to buy

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The End