

Chapter 1

Tarnished Gems: Value Investing

Warren Buffett is the modern-day heir of Benjamin Graham. Buffett knew Graham and his thinking very well: he took Graham's fabled class at Columbia University. Later, Buffett worked at Graham's Wall Street firm, Graham-Newman. He has eclipsed his mentor in one respect: Buffett has his own idolatrous sobriquet, the Sage of Omaha (he went back to his native Nebraska after tiring of New York). Graham is not so lucky. Some have called him the Father of Security Analysis, but that one never caught on.

The discipline of value investing has changed since Graham's time. Buffett learned from the master, then went on to refine his teachings to suit the current, more complex era. And while Buffett, like Graham, was never one to follow fads, he became one of the world's richest people by keeping an ear to the ground and adjusting his methods.

Graham, although well off, never achieved Buffett's stellar wealth. Since Buffett is still alive and ultra-rich, he has replaced Graham as value investors' role model.

The financial world Graham worked in, from the end of World War I through the mid-1950s, was a simpler place. The upheaval of the Great Depression aside, capital markets were rather staid during his career, at least in terms of how they operated. Institutions and rich people bought and sold most of the stocks and bonds. Brokerage commissions were fixed. Except during the occasional panic, trading activity was at a genteel pace. Buffett's long career, which started in the 1950s, has spanned a time of gut-wrenching change. Since the Eisenhower Era, America has been transformed into a nation with a much wealthier population and a much larger, more intertwined marketplace, one that takes more intellectual effort to comprehend. Buffett is the man who has bridged the gap between Graham's time and now.

At present, a huge amount of the U.S. population is involved in the market; fully one half of all American households are invested, mainly due to 401(k) retirement accounts or individual retirement accounts (IRAs), which have sprung up to replace old-style, employer-provided pensions. The level of homeownership has rocketed. Thanks to easy credit, Americans have taken on enormous debt loads. For a small fee with an online service, anyone can trade stocks from the comfort of his or her den. No one needs a broker anymore. Investing information, once hard to access, is widely available. The average person can glean news, corporate financial ratios, and stock performance from the Internet.

To a dizzying degree, the advent of electronics has speeded up trading. A stock can be bought in a nanosecond. The importance of the financial industry to the economy has expanded enormously as a result of all this. In Graham's time, financial services' share of the S&P 500 was in single digits. Now, even after the 2008 financial crisis, it is around 20 percent. A mind-bending array of new financial instruments has invaded the scene, from credit default swaps to structured products. Companies do business all over the globe, indulging in foreign currency swap strategies whose intricacies only a PhD could master. The swaps have evolved into exotic permutations that defy Graham's dusty analysis.

In the Graham fashion, Buffett has made a point of doing extreme due diligence before buying. But he goes beyond Graham in analyzing a company's products, prospects, and, above all, its operations. Graham, never a gregarious sort, confined himself to financial statements to tell him what he needed to invest in. Buffett feels it is vital to know the management of companies. Graham avoided this, fearing executives would try to snow him.

In late 2009, Buffett bought Burlington Northern Santa Fe for \$26.3 billion after a conversation with Matthew Rose, the railroad's chief executive officer. Buffett, who had owned a minority chunk of Burlington stock since 2006, knew Rose personally and had stopped by for a courtesy visit when he popped the question about buying out the railroad.

Often, Buffett examines a possible investment through a macroeconomic lens. Buffett's strategic reasoning to buy the rail carrier was based on his reading of broad transportation trends. Burlington is part of a four-railroad oligopoly that has divided up the country, meaning competition is sparse and barriers to new entrants insurmountable. That, coupled with the likelihood that energy prices are likely to trend upward over time, shows that Burlington has a future as a freight hauler, Buffett reasoned. After all, rail had proved itself to be better at transporting heavy cargo than trucks. Read any of Graham's books and you'll be struck by how seldom he looks at the macro picture when weighing an investment.

Graham rarely owned and operated entire companies, something Buffett routinely has done through his conglomerate, Berkshire Hathaway. Berkshire runs insurance companies, a candy maker, and myriad other entities—and also functions as a massive quasi-mutual fund with minority amounts of stock in traditional titans of business such as Procter & Gamble and Wal-Mart Stores. Berkshire holdings, whether they are minority or majority positions, usually are true to Buffett's dictum that they have a "moat around them." This means that, like Burlington Northern, they possess strong franchises that rivals have trouble breaching, the ability to raise prices, and steady revenues that build wealth.

Another difference with Graham is that Buffett is willing to take a flier occasionally on a questionable company, one perhaps beyond the

likelihood of redemption all value investors look for. Consider the insurer Geico, which both Graham and Buffett controlled at different times. Geico, one of the few companies that Graham actually had a hand in running, was in solid shape, yet valued at less than book, when its majority owner approached him in 1948. The weak stock price was a fault of market misperception, not of the firm's business model or management. Wall Street didn't understand its strategy of selling low-cost auto insurance to military families using direct mail, and sidestepping insurance agents. Coverage always had been sold by those friendly guys in insurance offices on Main Street.

Seeing a bargain with promise, Graham took over the company and served on its board, getting heavily involved in its inner workings. The insurer went on to prosper. But then it went awry. Almost 30 years later, during the ruinous 1970s inflation, a much larger Geico was teetering on the edge of bankruptcy due to poor claims management and pricing problems.

Graham, who had sold most of his Geico shares by then and left the company's board, never had an appetite for any business lacking his prized "margin of safety." By the 1970s, Geico had become very unsafe. Had Geico been in such sorry shape in 1948, Graham surely would have shied away. Buffett was different. Seeing a bargain where others saw nothing but disaster, he bought control of the insurer in 1976, installed new management, and eventually turned it around. Geico, he explained, suffered from a "local, excisable cancer."

Also in contrast with Graham, Buffett has been more willing at times to trust his gut, and occasionally more than he should. In recent years, he looked around and noticed that Ireland was booming and needed bank loans, spotted an explosion of arcane Wall Street products spurring demand for credit ratings, and saw oil prices spiraling ever higher. So he bought stock in the two Irish banks, in financial rating firm Moody's, and in oil giant ConocoPhillips.

These moves ended up costing Buffett dearly in 2008. The financial crisis battered Ireland's economy, vaporized financial exotica, and sent oil prices plunging. Gazing back in his 2009 letter to Berkshire shareholders, he admitted he had screwed up big time, especially buying the oil stock when petro prices were at a peak. "Pessimism is your friend, euphoria the enemy," he wrote in one of his shareholder letters.

One thing that separates value from growth investors is patience: the value folks say they will wait for a good stock to turn around, and some will stay with that good stock even after it does, expecting more upside. Unlike the unsentimental Graham, Buffett developed an almost unshakeable attachment to some holdings. Buffett famously has contended that a proper holding period for a stock was “forever.” Graham regularly took profits when a stock had gone up. At one point, he advised selling after a stock had climbed 50 percent.

In fairness, Buffett is not a purist about “forever.” He has culled his portfolio from time to time. Periodically, he sold because he realized he had made a mistake. He once thought buying USAir shares was a good idea, and shelved one of his core beliefs in the process. The airline hardly had a moat around it. Air travel is punishingly competitive. In the mid-1990s, tired of losses, fare wars, and other turbulence at USAir, he dumped the stock.

Many of the stocks that he married multiplied in value over the long haul, such as Coca-Cola (first share purchase was in 1988), Wells Fargo (1990), and the *Washington Post* (1973). Coke was the leading soft-drink maker, Wells the premier bank in expanding California, and the *Post* the circulation leader in the nation’s capital. When these companies ran into tough times later, Buffett hung on.

To be sure, Buffett enjoys advantages that few other investors or money managers possess. He doesn’t have to worry about meeting his kids’ college tuitions or paying his way into a retirement home. His grip over Berkshire, his vast fortune, and his huge reputation give him a lot of leeway others don’t have. In today’s volatile markets, people get very antsy. Should any Berkshire investors whine to Buffett about a particular investment that is doing poorly, he could easily ignore them.

In January 1998, Buffett bought 130 million ounces of silver at an average cost of \$5.88. In April 2006, he sold that stash for a little more than double what he paid, for an annualized gain of 13.6 percent. Not a bad haul after eight-plus years. But for the first few years he owned the metal, silver prices kept dropping. At one juncture, they were down 18 percent. His position didn’t cross into the black until 2003. As financial consultant Laszlo Birinyi put it: “If I, and most managers, held a position for five years and the position was down that much, clients would not have been very tolerant.”

Buffett usually has hewed to his core credos. One was that a holding should be understandable. So Buffett was dismayed in 2002 when he learned that one Berkshire asset, General Re, a large reinsurance firm he acquired in 1998, had a large tangle of derivatives, those complicated instruments that are tied to the value of other things like bonds. Derivatives are good at protecting against financial risk, unless there's a big systemwide crash, which is what later ended up happening to kick off the Great Recession. Buffett uses them sparingly, to hedge, never for speculation. Hedge funds often deploy them like gambling chips.

Buffett compelled General Re to unwind 23,000 derivatives contracts over five years. Thus, when the world blew up in 2008, and many derivatives were swept away, General Re was in relatively good shape. In his 2009 shareholder letter, Buffett wrote about the dangerous interconnectedness of derivatives, the risk that the other side of a contract will endanger your own position: "It's not whom you sleep with, but also whom they are sleeping with."

By the same token, Buffett has usually avoided technology stocks because he does not understand their businesses. At first blush, he was wise to be skeptical of the Web stocks that took flight in the 1990s and then spectacularly crashed. Many of those were built on dreams, not hard business realities. Graham also was suspicious of tech, which had started to rise toward the end of his life. In the late 1960s, he observed that the success of IBM was sure to inspire the founding of many other tech firms that had poor prospects.

For Buffett and Graham, the worst sin of tech stocks is that they tend to be growth oriented. In other words, their revenues—or at least their projected revenues—were expanding rapidly, and so were their stock valuations. Since value investors want to buy cheap, investing in such issues is heresy. A lofty price-to-earnings ratio (P/E), the measure of whether a stock is cheap or expensive (the stock price divided by the past four quarters earnings on a per-share basis), is a badge of dishonor to a value aficionado.

But Buffett's broad-brush dismissal of tech likely is short-sighted and shows the limitations of the value credo. Interestingly, Microsoft, which went public in 1986, always had a high P/E. Up until the 2000–2002 tech crash, the software maker's price had risen exponen-

tially. Those who had invested early on became very rich, even after the price ebbed some in the new century. Had Buffett gotten heavily into Microsoft, he would be even richer.

Buffett developed a friendship with Bill Gates, Microsoft's chief and a fellow billionaire, who regularly has traded places with Buffett as the world's richest person, by *Forbes* magazine's tally. Aside from their wealth and a passion for bridge, the two share a background: they had been smart and gawky youngsters. The two men sometimes appear together in public forums and discuss the issues of the day.

Buffett donated a bunch of his wealth to Gates's charitable foundation, but never became a big Microsoft investor. To be polite, he owns a smattering of his friend's shares. Value guys usually don't go there.

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Like Graham, Buffett started out in life as a geeky, numbers-obsessed type. Neither man was much of a looker, but they more than compensated by their brains and drive.

Buffett's father, Howard, was a stockbroker. Hanging out in his father's Omaha office, the younger Buffett became fascinated with stocks and took to charting their movements. Howard also served as an arch-conservative Republican congressman in the 1940s. From Howard, Buffett learned the value of independence. Howard was a staunch opponent of organized labor and the New Deal—an unpopular stance in the Age of Roosevelt. Attending a baseball game with his dad, Warren marveled at Howard's nonchalance when the crowd booed him. The man believed in enhancing “liberty,” and the hell with what the rabble thought.

After a couple of years at Penn, young Warren felt he wasn't learning much, so he returned home and finished at the University of Nebraska. After reading *The Intelligent Investor* and hearing about Graham's fabled class, Buffett went to Columbia University for graduate work. One of 20 students in Graham's class, many much older and some working on Wall Street, Buffett quickly became the star. His hand regularly shot up. Discussions between the kid, barely out of his teens, and the professor dominated the proceedings. Graham gave Buffett an A-plus, reputedly the only one he ever awarded.

Buffett drank deeply from Graham's wisdom and even bought some of the stocks that the Graham-Newman firm owned. He learned not to follow the Wall Street herd. He learned that, to Graham, the stock market was not a "weighing machine," where value was determined precisely, but rather a "voting machine," which a lot of people used to register their opinions based on both logic and emotion. He learned that great opportunity could be found in cheap stocks, characterized by Graham as "cigar butts." He learned that stocks had an "intrinsic value," their true worth, not the market's sometimes benighted assessment.

Once Buffett graduated in 1951, he naturally asked Graham for a job. But the master, who had been born Jewish, turned him down. Roger Lowenstein, in his superb *Buffett: The Making of an American Capitalist*, writes that, at the time, "Jews were locked out of gentile firms, and Graham preferred to hold his spots for Jews." It never occurred to the gentile Buffett to work for anyone else on Wall Street. So he went back to Omaha and started at his father's brokerage firm. This was unsatisfying for the young Buffett, who specialized in research, yet found many of his clients unappreciative.

He kept in touch with Graham via letters, and eventually his old teacher offered him a job. Back he went to New York with his new wife and rented a cut-rate apartment in the suburbs, even though he could now afford more opulent digs.

At Graham-Newman, Buffett learned even more. After a time, though, he chafed under Graham's cautious stewardship. Lowenstein recounts how Buffett and Graham argued about Buffett's practice of visiting companies. Plus, Buffett thought Graham was sitting on too much cash, when he should have put more of it to work.

Come 1956, Graham had gotten tired of Wall Street, so he folded the firm and moved to California to teach. Rather than stay on in New York, whose pace wearied him, Buffett decided to return home once again. By this time, he had amassed a decent wad of capital himself, and he could go into business solo. No more working for his dad or his intellectual dad, Graham.

At his new firm, Buffett began to dazzle as he bought value stocks that went on to vault in price. One such investment was in American Express, which had gotten embroiled in a scandal involving a subsidiary that stored salad oil, and used it as collateral for loans. There was very

little salad oil in the AmEx division's storage tanks. Fraud arrests ensued, and the subsidiary filed for bankruptcy. The stock of parent AmEx took a dive.

Buffett saw opportunity. People, he observed from visits to stores and to restaurants, were starting to use the company's charge cards in droves. In 1964, Buffett bought lots of American Express shares. And he has kept them to this day. The stock, which has suffered ups and downs through the years, has been a net winner for him.

Along the way, Buffett acquired an ailing textile maker in New England, known as Berkshire Hathaway. The stock was tantalizingly inexpensive—and in a dying industry. Buffett didn't care that Berkshire had no moat because he had little interest in textiles. He used Berkshire as a vehicle to get into areas that were more promising, like insurance. And he closed its mills, which consumed capital with little chance of a turnaround. Graham would have been appalled at this audacity.

Graham-Newman was a public company, so one wonders what the thrifty Graham would have thought of Berkshire stock. The Berkshire A shares have topped \$100,000 each; the more affordable B shares were more than \$3,000, until they were split to a much lower price, under \$100, after the Burlington deal (The Burlington takeover payment was partly in Berkshire stock, which thus needed to be sliced into smaller, cheaper units.) Graham-Newman stock went for \$30 in 1949, which is around \$260 in current dollars. Not cheap, but not unreachable either.

Also, Graham's company paid its investors dividends. Buffett never has, preferring to hoard the cash so he can deploy it as he wishes. Berkshire stock has a P/E of around 16, comparable to that of the broad market. That sounds affordable, but not when you look at the six-digit price of the A shares. Value investors may love Buffett, but there's an irony if they own his pricey, non-dividend-paying shares.

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Buffett's down-to-earth Midwestern persona has an unspoken message for investors: regular folks can aspire to be like him. Here is a guy who, with his folksy manner and unpretentious ways, could be your neighbor. You might bump into him at a fast-food outlet or the mall. He

doesn't drive a flashy car or live in a palace. His house is unassuming, located in a pleasant if unfancy neighborhood. Like many Americans, he could stand to lose a few pounds and has a weakness for junk food—ice cream, Cherry Cokes, cheeseburgers.

This aw-shucks personality masks someone who, like his mentor, enjoys the limelight. The Berkshire shareholders' meeting is a massive gathering whose main purpose is his veneration. He from time to time appears on CNBC, always treated with deference. Anything he does or says makes news. His takeover of Burlington Northern was splashed on newspaper front pages worldwide. If Henry Kravis, the private equity king, had bought the railroad, the news stories would have gotten less play. Buffett got a lot of notice supporting Barack Obama for president, and again when he complained that the Obama administration's agenda was too ambitious. In public appearances, Buffett—as a young man, so terrified of appearing before crowds that he took a Dale Carnegie course—has the poise and warmth of a master politician.

Buffett has fostered the image of an approachable demigod. Listening to Buffett talk and reading his ideas, you get the impression that investing is a matter of common sense. Hard work is involved, obviously. But his special genius is to show that everyone can do this. Maybe not everyone can become a billionaire. They can come out ahead, nonetheless.

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Value investing is not the sole path to salvation. It just happens to be Graham's and Buffett's path. The question for growth investors is: will this stock keep soaring? The question for value investors: is it a cheap, underappreciated stock that is good enough to someday take off? Growth investing is a sprint; value investing is a marathon. Stock prices are supposed to reflect future earnings. For value types, the key is divining what has staying power. And to do that, there are math methods to assess earnings potential.

Philosophically, they all spring from the formula that Graham devised to find the "intrinsic value" of a stock—in other words, its true worth. Maybe a stock is selling at \$20 a share, pulled down because its industry is out of fashion or its earnings suffered a hiccup due to a

temporary problem. The classic Graham formula may show that the true value of the stock is \$50. So if you buy this “cigar butt” now, you get a bargain, and can patiently sit back until the market wises up to its actual worth. That’s assuming the market ever does, but more on that in a minute.

Graham’s intrinsic value formula is:

$$E(2R + 8.5) \times 4.4 / Y$$

Here, E is a stock’s earnings per share, R is its projected growth rate, and Y is the average interest rate on high-grade corporate bonds. As to the numbers, 8.5 is the P/E for a company with no growth, a sort of a baseline, and 4.4 the bond yield (interest rate as a share of price) in Graham’s day. Few stock strategists still use this formula, which mainly is geared toward a world where the overwhelming number of stocks were cheap, during and after the Depression. Remember that the market didn’t fully recover from the 1929 crash until the early 1950s, a few years before Graham left professional investing. Nowadays, U.S. government bonds are the benchmark most often used, since they presumably are free of default risk. And the 4.4 number may not do justice to current interest rates. High-end corporate bonds and Treasury bonds usually yield more than that, albeit the Treasuries were below 3 percent in the aftermath of the Great Recession as investors flocked to them for safety.

Various market thinkers have concocted new formulas to find a 21st-century intrinsic value. One of the most widespread is the so-called PEG ratio, which is the current P/E divided by a company’s earnings growth rate. Some use the company’s past growth rate, which carries the risk that its best days are behind it. Many use earnings estimates, which give the assurance (perhaps misplaced) that the future is knowable. In any case, a PEG ratio below 1.0 is considered cheap. The higher you go above 1.0, the pricier the stock. The PEG ratio, lamentably, never tackles the question of a company’s quality.

Joel Greenblatt, a managing partner at New York hedge fund Gotham Partners, attempts to do that. His investing choices are guided by what he calls the “magic formula.” This approach, which he outlines in his *The Little Book that Beats the Market*, argues that the best way to cull out the most promising value plays is to focus on earnings yield

and return on capital—his yardsticks for whether a stock is cheap and good quality.

Earnings yield, which is the P/E inverted, is a gauge of how much earnings a company throws off in relation to its price. If the earnings yield is high, it likely shows that the business is a good profits generator and yet the stock trades at a bargain price. Return on capital measures how much earnings are generated by a company's factories or stores or whatever marks its tangible worth. Greenblatt likes stocks with high scores on both counts. He takes 3,500 stocks available for trading in the United States and makes two separate rankings using his two measures. Then he combines them to find the best overall scorers. Greenblatt contends that his method has had an extraordinary record. In late 2009, he launched an online money management service using his strategy.

The point of these formulas is that the average person can suss out intrinsic value. This is simple math. Of course, other considerations enter into the mix. Graham wanted a stock whose P/E was 0.4 of the highest P/E it had hit in five years, meaning its price was on the downswing. In his quest for a company with low debt, he insisted that the debt be less than tangible book value—which is the amount that you would get by liquidating all the business's assets. Those investing metrics remain reasonable. Old Ben still has much to teach us, after all.

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But other Graham measures haven't fared well, perhaps unjustifiably. He put a lot of store in dividends, a notion some today view as antiquated. Tech and other growth companies usually disdain these payouts to investors, reasoning that growing businesses are best served by keeping all the money to expand and improve operations. Graham liked a dividend yield (the dividend divided by the stock price) that is two thirds the yield of a high-grade corporate bond. Anything higher than that, in his view, was too risky: A company might have trouble paying a lofty amount and end up cutting it, which would hurt the stock price. Or a very high dividend might signal that a stock price is too low for a reason—the market correctly surmises that the stock is lousy.

Buffett has been less vocal about dividends, but only a handful of Berkshire's holdings don't offer them. Many value buffs these days

remain keen on dividends, which tend to be paid by reliable stalwarts lacking in flash. Industries that customarily award dividends, such as utilities and consumer staples, typically are less expensive than the broad-market S&P 500 stock index.

A sizable overlap exists between dividend-oriented and value investors. Money manager David Dreman, a celebrated voice in the value community, wants stocks with solid and growing dividends—that is, the company keeps increasing the payouts at a consistent pace, year in, year out. He calculates that steady dividend raisers do well in stock-price terms over the long haul.

After all, they tend to be blue chips with strong balance sheets, a comfort to investors. Their key advantage is that they pay investors to own them. Standard & Poor's has a list it calls the Dividend Aristocrats, showing companies that have raised payouts 25 years in a row. This gilded roster has outpaced much of the market for a long time.

During bear markets, Dreman notes in his book *Contrarian Investment Strategies: The Next Generation*, dividend-paying stocks hold up better than nonpayers in downturns. Payers on the S&P 500 index were badly mauled in 2008, when they dropped an average 39 percent. Nevertheless, stocks with no dividends were hurt even worse then, down 45 percent. Reason: They lacked the cushion that dividends provide.

Since 1972, reckons Ned Davis Research, companies that increased or started paying dividends have returned 9.5 percent yearly on average. Investors tend to punish those that pared or eliminated payouts. Such moves are seen as admissions of internal woes. These stocks lost 1.8 percent annually since 1972. Those that never paid a dividend gained only 1.2 percent. In 19 of the past 30 years, S&P data show, payers' shares did better than nonpayers'.

Nonpayers' stocks have done best when technology issues are popular, like in the late 1990s—since few tech firms pay dividends—or they outperform in the immediate rebound from a bear market, when relieved investors regain a zest for riskier stuff. So for much of 2009 nonpayers were ahead, up 56 percent, with the likes of Amazon.com, Starbucks, and Tenet Healthcare more than doubling in price. The last year where nonpayers did better was 2003, in the snapback from the tech bust.

The trouble with dividends is that fewer companies offer them of late. And during the Great Recession, many payers either eliminated

dividends or slashed them badly. In late 2008 and early 2009, payout cuts were rife in financial stocks, once a dividend cornucopia. As huge banks teetered on the brink, it made sense to pare dividends to bolster waning capital. In 2007, Bank of America paid \$2.40 per share yearly in dividends, yielding more than 5 percent. That was clipped to four cents a share. Meanwhile, the stock fell from \$44 to \$3 in March 2009, and has moved up again—but only to around \$14 in early 2011. Its current yield is a microscopic 0.3 percent.

With corporate cost-cutting all the rage after the Great Recession, many companies started hoarding cash rather than sharing it with investors. Aluminum giant Alcoa Inc., which boasts \$1.1 billion in cash and cash equivalents, shrank its dividend 82 percent in early 2009. After a string of losses, the savings helped it return to the black.

All that said, Dreman reasons, high-yielding stocks are a better place to be than bonds if there is a rise in interest rates, the bane of bond prices. For every 1 percent increase in interest rates, a 30-year bond will fall 12 percent in price.

Odds are that stocks will be less affected by rate boosts. Often, but not always, a slump in bond prices is good news for stocks, especially if the stocks raise their payouts. “Dividend payments go up over time,” he writes, “interest payments on bonds do not.”

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David Dreman is a mild-mannered fellow whose Dreman Value Management sits in Wall Street West, the cluster of financial firms in Jersey City that’s a subway ride away across the Hudson River from the celebrated district in Lower Manhattan. But he has a fierce devotion to value investing and loves to defend it against all comers. In early 2000, as the tech craze neared its apogee, Jim Cramer, later of CNBC fame, wrote in *TheStreet.com* investor site that Dreman was a stodgy type unwilling to chase the hot stocks of the moment. Dreman fired back promptly. “In a great market for Internet stocks,” he wrote in his *Forbes* column, “a day trader who is fond of them can make money—for a while.” I edited this column at the magazine, and I marveled at how feisty Dreman became on the subject. “Cramer is full of hot air,” he told me with atypical annoyance.

With the hot-eyed certainty of a tent revival preacher, Dreman insists that value investing is better than growth investing. He crunched some numbers to prove it, using a broad group of stocks called the Compustat 1500. Sure enough, he found that from 1970 through 2008—an era that encompassed stagflation, two roaring bull markets, and two horrendous busts—value trumped growth. That was true regardless of how big the stocks were. For those with market values over \$10 billion, value grew at 12.3 percent annualized, while growth dragged across the finish line at 6.7 percent. For small stocks from \$250 million to \$1 billion, the story was much the same—a 17.4 percent advance for value versus a mere 10.5 percent for growth.

Hmm, aren't these numbers a tad suspect coming from one of value's staunchest champions? Well, it turns out that Dreman is right, using other metrics. Russell Investments, which is a pretty fair broker in this debate, keeps two indexes, one for value and the other for growth, measuring even more stocks than Dreman does, 3,000 for each. While the results aren't as stark, they do show that value prevails over the fullness of time. For the 10 years to the end of 2009, for instance, the Russell 3000 Value Index was up an annualized 2.97 percent, and the Russell 3000 Growth Index was a negative 2.28 percent. And that was so despite superior earnings from growth. The growth index had an earnings expansion of 16 percent and the value list just 3 percent. Yet, as always, the numbers show that growth stocks can be, well, overvalued. The growth index had a price/book ratio—often the best way to measure valuation since earnings more easily can be erratic or manipulated—twice that of its value cousin.

Dreman styles himself a contrarian because his stocks often are out of favor. The reason value triumphs in price performance, he argues, is that when the market wakes up to the true worth of these bargain stocks, it showers them with love. However, investing in a growth stock means you are paying a lot for something whose run may soon peter out. The go-go tech stocks of the 1990s are a prime example. Pets.com seemed like a really good idea, allowing customers to order dog food deliveries, until the sizzling stock burnt out and its ashes spiraled into oblivion. "At times, no price seems too high for aggressive growth stocks," Dreman writes in his book. "Investors repeatedly pay through the nose, and just as repeatedly get stung." Instead, he

counsels, go for the “blue chip stocks that widows and orphans traditionally choose.”

Stocks, Dreman preaches, will always do something called “regress to the mean.” That is, if the market shoots up to an extraordinary degree, it eventually will fall back to its customary pattern. The average P/E of the S&P 500 over time is 16. During the dot-com boom, that number rose above 30. Once the bubble popped, it fell back to its usual level. “Don’t be seduced by recent rates of return for individual stocks or the market when they deviate from past norms,” he writes. “... If returns are particularly high or low, they are likely to be abnormal.”

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As Buffett has shown, the best value investing nowadays ventures beyond the confines of a financial statement. That means focusing on who is in charge of companies, delving into their strategies (whose merit may not be obvious yet), and detecting who is riding incipient trends.

Nowhere are the skills of a chief executive as important as in a turnaround situation, where a company has gotten itself into a jam and needs to be fixed. The market has given up on the stock and written off the company as yesterday’s news. For a value manager, the trick is to find a floundering enterprise whose basic business is sound. It’s the execution and strategy that are at fault. Not everyone has the skill and moxie to correct problems. Being sure that the right person is in command of the turnaround is no easy task.

Lloyd Khaner is the sort of value investor who keeps an eye on executives. That’s one reason that his hedge fund, Khaner Capital, has had an extraordinary run since it started in 1991, even though it doesn’t take on lots of debt, which is a hallmark of many hedge operators. In 2008, a horrible year for almost everyone, when the S&P 500 dropped almost 40 percent, he succeeded in holding Khaner Capital’s losses to just 14 percent. He looks for companies with manageable debt loads and good cash flow, yes. He avoids those in dying industries, yes. But the question of who is in charge is the real key. As Khaner puts it: “Decision making is critical. New computers, machines, and business models are worthless without the right people using them.”

Khaner’s 2005 investment in Campbell Soup is an example. The company, founded in the late 1800s, had been a laggard contender in

the food arena for too long. The firm went 10 years without any new core products and ritually jacked up prices by 10 percent annually. Then Campbell brought in a new chief named Doug Conant, formerly of Nabisco, who was determined to shake things up. Khaner, knowing Conant's reputation, was intrigued. Conant was the sort of person who writes dozens of thank-you notes daily to employees, suppliers, and customers. He had a firm grasp on the simple, yet often overlooked, concept of leadership—that it is often a matter of getting people behind you.

Khaner recognized that Conant had something valuable to work with in Campbell. Its brands still were iconic and widely used—the typical U.S. household often had several of its cans in the pantry. How to get it moving again? Conant booted 300 of its top executives, and he sold noncore products like Godiva chocolates. Most important, he revved up morale by telling employees that the company's low state was not their fault, and set about enlisting them to help him to locate and implement ideas. A rush of new products appeared, emphasizing convenience. Campbell introduced a microwaveable soup package, for instance. Conant marveled that the microwave had been invented in 1948 and was ubiquitous in American homes, yet Campbell hadn't caught up with that. Soup sales surged. So did the stock. So did Khaner's returns. Revenue and earnings did later dip due to the recession, and so did the stock, only to recover in 2009.

For a true value investor, discerning when a company has found a good new strategy is not easy, especially when the news around the company is negative. Kian Ghazi of Hawkshaw Capital Management zeroed in on a supplier for convenience stores that was dominant in the western United States named Core-Mark Holdings. Thus, it had a Buffett-style moat. Trouble was, Core-Mark's key product, cigarettes, was suffering from declining sales. Historically, tobacco has made up one third of convenience store revenues. The stock price reflected that unpromising reality, and the shares changed hands for a mere six times earnings. Ghazi saw that the company had a smart plan to move past that obstacle. Core-Mark was betting on a move into fresh foods like salads, sandwiches, and fruit cups. With gross margins on those items ranging from 15 to 25 percent, versus 4 percent for cigarettes, the new strategy had the trappings of a winner. The stock at last began climbing in 2009 on the strength of the new strategy.

Then there's identifying companies that are riding trends. As the Great Recession dragged on and consumers sat on their wallets, veteran value manager Chuck Akre figured out ways to invest in stocks less tied to people's everyday spending. "The consumer is strapped and I am cautious," he said in late 2009. Wise value investing has carried him far through the years. His mutual fund, FBR Focus, lost less than the market in 2008, and in the century's first decade, it racked up an 11 percent annual return, at a time the S&P 500 had essentially gone nowhere. In 2009, he split from FBR Capital to form his own fund, Akre Focus, employing the same insights.

What kinds of companies, he asked himself, would do well in an age of muted consumer demand? Figuring that usage of cell phones would remain robust, he favored American Tower, which owns the towers used in cell transmissions. He admired the company for carrying half the debt to EBITDA (a measure of earnings that doesn't subtract interest, taxes, and intangible accounting charges) of rivals. Although advertising was in the dumps, he believed that billboards would fare better since they were harder to ignore—as they line the roadside, you can't fast-forward or flip past them. Lamar Advertising, a big presence in this area, was his choice. Another plus, in Akre's eyes, was Lamar's bold push into digital billboards, which made it a very flexible player. While earnings lagged during the recession, the company was able to keep revenue up, portending a brighter future.

Amid lame auto sales after the financial crisis, Akre decided that a good company selling auto parts would thrive. His thinking: with people keeping their cars longer, repairs would become a bigger industry; and demand for auto shops and do-it-yourselfers would leap. That trend was helped along by the closing of many auto dealerships as the Detroit Big Three contracted in size. He was right, investing in O'Reilly Automotive, a parts retailer. These three Akre picks responded as he hoped. His system worked.

★ ★ ★

Unfortunately, value investing as a whole has endured long spells of subpar performance and, for some individual value stocks, horrible disasters. The late-1990s, when the tech boom roared, and the Great

Recession were not good to certain value stocks like financials, to say the very least.

True-blue value buffs, certainly, tried to ride out these bad times cleaving to the old teachings. Graham counseled that an investor should hold up to 30 securities to provide the safety of diversification. He realized that not all the holdings in a value portfolio, even a meticulously researched one, could be winners. The goal was that, on average, the entire grouping would rise, with winners overpowering losers. An important coda, often championed by Buffett, was that patience was needed. Value investing is no place for someone who needs instant gratification. Panicky investors, who had bought expensive shares during the 2002–2007 bull run, dumped their stocks amid the March 2009 market nadir—the exact wrong step, buying high, selling low—and later suffered for it.

Diehard adherence to the value creed, however, can lead even the smartest investors into something called a “value trap.” That is a stock whose low P/E seems to signal a great bargain. Some stocks deserve a low valuation. Citigroup, the giant bank, teetered on the edge of oblivion during the financial crisis. But since Washington judged it too big to fail, massive federal help righted it. The stock, which had been at \$35 in 2007, cratered to \$1 in the depths of the bear market. Later in 2009, as financial issues rallied, it climbed back to \$5. Still, it continued to be saddled with many problems, from rotten assets stinking up the balance to a clumsy structure that consumed executive time and energy.

John W. Rogers Jr. has a fund company called Ariel Investments, whose symbol is a turtle. Rogers is fond of quoting Leo Tolstoy: “The strongest of all warriors are these two, time and patience.” The turnover rate of his flagship Ariel fund is very low, usually around 20 percent per year or less. Rogers studiously works out the intrinsic value of stocks that interest him, and after he buys, embraces them with a near-religious fervor. Sticking with his most beloved stocks is ingrained in him.

Habitual behavior is his hallmark. According to Lauren Young, writing in *SmartMoney* magazine, every day he eats the same food for lunch (a McDonald’s burger, fries, and Diet Coke) and wears a charcoal gray suit (he has a rack of identical ones). Young quotes his ex-wife,

Desiree, who went on to a job in the Obama administration, saying: “You try living with that, honey.” One of the most prominent African-Americans in finance, a long-time supporter of fellow Chicagoan Barack Obama, and despite the diet, almost as trim as he was when playing basketball for Princeton, Rogers owes much to his diligence and consistency.

Rogers has an enviable 10-year record, with returns that easily best those of the S&P 500. But he had a very bad 2008, when Ariel slid a sickening 48 percent, far worse than the market. One cause was his steadfast ownership of newspaper stocks. Even before the Great Recession hit, circulations had been declining because people could more easily get their news from the Web. Not helping were expensive consolidations in the field, paid for with worrisome amounts of debt that became harder to service as ads fled. In a 2006 *Forbes* column (which I edited), Rogers argued that newspapers should be fine over time, since Google and the like could never match their local coverage. Plus, he noted, many papers had started successful web sites.

The weakness of this argument was that the Internet became an even more formidable competitor to the dead-trees industry. Digital media have the advantage of much lower fixed costs—no costly union contracts, newsprint purchases, and delivery truck fleets to maintain. And newspaper web sites couldn’t charge as much as the print versions, hence they weren’t the papers’ saviors. The descent of newspaper stocks was harrowing. The worst was that of Tribune, owner of big-time names like the *Los Angeles Times* and the *Chicago Tribune*, which swash-buckling Chicago financier Sam Zell had bought with the aid of too much debt and no notion of what it took to turn the enterprise around. Tribune careened into bankruptcy court.

Patience, so often touted as a value-investing virtue, sometimes ends up as an investor enemy. According to data from Financial Research Corporation, the average large-cap value mutual fund turned over its portfolio in 2009 by 75 percent. The average growth fund had a 112 percent turnover. The numbers mean that growth managers were more eager to cash in on gains and move to the next hot prospect. The value people were much more cautious, and at times waited too long to ditch losers.

One of the worst hurt by misplaced patience was Bill Miller, the venerated value guru who oversees investing at fund house Legg Mason, and manages its vaunted Value Trust. Like Rogers, Miller usually has a very low turnover, around 20 percent.

What happened to Miller in the 2008–2009 bear market bordered on tragic. His Legg Mason Value Trust outpaced the S&P 500 each year from 1991 through 2005, a record no one has equaled. He developed a yen for financial stocks, favoring them when they were under the most pressure. In the early 1990s, amid the savings-and-loan crisis, financials were at a low ebb—hence, Miller bought a lot of them cheaply. When they recovered, his portfolio soared. As the financial crunch began in 2007, he also discerned a buying opportunity in financials. Although two Bear Stearns hedge funds had collapsed that summer, he loaded up on Bear. As financial stocks kept dwindling, he kept buying: Merrill Lynch, Freddie Mac, Wachovia, Washington Mutual. These turned out to be a roster of the damned. Even after Bear blew up in spring 2008, he got deeper and deeper into financials.

After a small loss in 2007, his fund plunged a harrowing 55 percent in 2008. Investors scrambled to get out, and Value Trust shrank from \$20 billion in assets at its peak to a mere \$4 billion. Big corporate and pension-plan investors, a sophisticated group, were no exception. “I served on boards where they said, ‘Get rid of Bill Miller—now,’” recalls fellow value manager Rogers. Miller rode the storm out, and in 2009, with the market recovery and a renewed appetite for surviving financials, again outperformed the market. Yet he faced a long climb to recover what he had lost during the bad season.

Say this for value managers like Dreman, Rogers, and Miller: They have the courage of their convictions. Dreman had a stellar record with a fund called DWS Dreman High Return Equity, which he ran for its parent Deutsche Bank. He had a fervent belief in Fannie Mae and stuck with its stock during an earlier accounting scandal. Amid the financial crisis, the government took over the mortgage firm, and its stock sank. After Dreman’s fund clocked a 45 percent loss in 2008, the bank canned him as a manager and renamed the fund.

Explaining the problem later, Dreman says, “Investors overreacted to events.” When they do, value stocks are a scary place to be.

Walter Schloss: At the Master's Table

In his mid-90s, veteran value investor Walter Schloss is alive with memories of his career working at Benjamin Graham's firm, alongside a young up-and-comer named Warren Buffett. Schloss, who now lives in a swanky Park Avenue apartment with a lofty view of Manhattan, managed money for private clients until the early 2000s. In 2001, a rotten year in the market, he says his accounts were up 12 percent.

"You may lose at times, like in 2008," he says with a toothy grin. "But it pays to be an optimist. My father died at 103. I want to beat him."

By Schloss's reckoning, in the five decades as a sole investment manager after leaving Graham, he averaged 16 percent yearly, versus 10 percent for the S&P 500. After dissolving the firm he ran with his son in 2003, he continued to invest his own multimillion-dollar portfolio, using Graham principles. In a famous speech at Columbia in 1984, entitled "The Superinvestors of Graham-and-Doddsville," Buffett cited Schloss, along with legends like William Ruane of the Sequoia fund, as exemplars of value that good investors should emulate.

"Ben Graham changed my life," Schloss says, recalling how he came across *Security Analysis* as a young man in the 1930s. Schloss, living in near-poverty in Depression-stricken Brooklyn, was an ill-paid runner at a Wall Street firm, meaning he was the gofer who carried stock orders and documents around the office. He took a class that Graham ran at the New York Stock Exchange, a version of his celebrated Columbia sessions, and impressed the great man. After World War II service as a code cracker, Schloss landed a job at Graham-Newman.

Schloss owns no computer and follows the market with the help of the daily newspaper and Value Line investment reports. He also makes sure to stick to the Graham verities. He wants stocks with low price-to-book and very little debt. Plus, he knows that disappointments litter a value investor's path. One of his stocks, a compressor maker called Tecumseh Products, had fallen from \$35 in 2008 to \$8. Schloss can rattle off all

Walter Schloss: At the Master's Table (Continued)

manner of stats about the company. And as he rolls through the bad ones about Tecumseh, he grimaces. By late 2010, it had only recovered to \$12. "That one is a shame," he says.

The real test for a value investor: "A stock has lost half, and you go in and buy more. That is not easy. People will think you are crazy."

Summary

- Warren Buffett, the modern-day heir of Benjamin Graham, has updated the master's concepts of value investing. In addition to Graham's devotion to fundamentals, Buffett wants to know a company's management, sometimes applies macroeconomic analysis, and will take an occasional flier on a dubious-seeming investment. Sometimes, he lets his gut guide him—as it did, to his sorrow, when he invested in Irish banks.
- Buffett, though, still hews to such core beliefs as: an investment should be understandable to the investor. That's why he normally shies away from tech issues and derivatives.
- Graham's notion of "intrinsic value," which seeks to find a stock's real worth, has been refined. Value money manager Joel Greenblatt, for instance, uses the nexus between earnings yield and return on capital.
- Dividend-paying stocks, another time-honored value favorite, have had their problems but they still win the plaudits of value icons like David Dreman. Studies still show that these stocks outpace nonpayers over the long pull.
- Value stocks, by many analyses, do better over time than do growth stocks. One reason is that they have higher to rise and are innately strong, not just fads.
- But value stocks have weaknesses. They have endured bad times, too, as during the tech boom. Also, there are such problems as the "value trap," where cheap stocks only get cheaper, hurting investors. That happened to financial stocks, a value stalwart, during the 2008–2009 bear market.

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