Module # 1 – Component # 1

"Famous investment strategies – Value Investing"

An analysis of the approach taken by some of the world's most famous investors. In this component the value-based styles of Benjamin Graham, Geraldine Weiss and Ralph Wanger are analysed.

Foreword: This is the free course on the Investor Campus website (www.investorcampus.com). Investor campus provides educational material for both the professional investor and the Individual who is investing in financial instruments. In order to provide a course which is suitable to both audiences, we have highlighted the strategies of some of the world's most famous and successful investors. Both professionals and amateurs alike can learn from these experiences.

This is the first component of the Module "Famous Investment Strategies", where we look at how famous investors have used differing strategies to achieve above average returns.

Objectives

To show students the investment strategies of three of the world's most famous value investors - Benjamin Graham, Geraldine Weiss and Ralph Wanger. By analysing what strategies other successful investors have followed, to achieve above average returns, students can develop their own style.

Expected Outcomes:

? To understand the investment styles of Graham, Geraldine Weiss and Ralph Wanger

? To understand the basics of value investing

? To appreciate that many different investment styles can result in above average returns

? For a student to begin developing his/her own views on what investment style will work

Benjamin Graham – Classic Value Investing

Benjamin Graham is one of the proponents of value investing and is considered one of the "fathers" of this discipline. He believes that one should not deviate too far away from the **intrinsic value** of a company; ie. that determined by fundamentals such as earnings per share, dividend yield, financial strength and importantly tangible assets.

Graham also believed that more **amateur investors should limit themselves to strict criteria** so as not to become victim to stock market over and under optimism when particular shares or industries become irrationally valued by the market as a whole.

Stocks which will beat the market are typically those that have superior earnings growth. However, the reality is that:

- It is almost impossible for investors to be able to judge in advance which share will achieve this, and
- This superior growth may already be priced into a share price.

This makes "**growth investing" very risky**. Better returns can be achieved by having the downside limited by having a base of strong fundamentals – this reduces the risk of misjudgement. Investing in shares which have this underlying value (the share price is trading around the intrinsic value) have less risk and a combination of this and good growth prospects is a desirable positioning for an investor.

Graham also differentiated between two different types of investors**:** **"defensive" investors** (those who did not have the time or knowledge to get the inside track on a company) and **"aggressive" or "enterprising"** investors (those with a higher appetite for risk or a higher level of professional training.

Graham felt that defensive investors should restrict their stock universe to large companies with strong track records and intrinsic value. More aggressive investors could expand their stock universe materially, but again not stray too far from intrinsic values. Graham believed that all investors should stay away from new share issues.

Graham's rules for defensive investors are shown in Figure 1 and rules for enterprising (aggressive) investors are shown in Figure 2.

Graham's Rules for Defensive Investors

1) **Market sector**
Companies should be analysed with reference to their industry group. Graham differentiated between utilities and other sectors

2) **Adequate size of the enterprise**
Exclude smaller firms which carry more risk. Adjusted for inflation, Graham suggested staying away from companies that have sales below US$300m

3) **Financial condition for non-utilities**
A 2:1 current ratio
Long term debt should not exceed working capital (current assets less current liabilities)

4) **Financial condition for utilities**
Debt should not exceed twice the stock equity at book value

5) **Earnings stability**
Positive earnings for at least the last 10 years

6) **Dividend record**
Uninterrupted payments for the last 20 years

7) **Earnings growth**
3% annual growth rate over the last ten years

8) **Moderate P/E ratio**
Graham specified that the average for the last three years should be less than 15x

9) **Moderate ratio of price to assets**
The share price should not be more than one and a half times the book value of the share

Graham's Rules for Aggressive Investors

1) **Low P/E ratio**
Graham felt that investors should focus on shares whose P/E ratios were among the lowest 10% of the market

2) **Financial condition**
A 1 1/2:1 current ratio
Long term debt should not be more than 110% of working capital (current assets less current liabilities)

3) **Earnings stability**
Positive earnings for at least the last 5 years

4) **Dividend record**
Some current dividend payout

5) **Earnings growth**
Last year's earnings should be higher than that of 5 years ago

6) **Moderate ratio of price to assets**
The share price should not be more 120% the book value of the share

Ralph Wanger – Theme Investing in Smaller Cap Growth Companies, it a Reasonable Price

Ralph Wanger is the portfolio manager of the highly successful Acorn Fund. He has been a consistent promoter of small-stock investing and his Fund (which has been around since 1970) is one of the most successful.

Wanger's approach is to invest largely in small market capitalisation shares, with as limited risk as possible.

He summarises his own philosophy: "Maintain **independence** of thought and a healthy degree of **scepticism**, so you won't be drawn into the herd. **Don't overpay**, no matter how much you like the company. Invest in **themes** that will give the company a long-term franchise. Invest **downstream from technology**. Think and invest **globally**. Find stocks to **own**, not trade."

While Wanger does invest in larger capitalisation companies, he favours those with a smaller market capitalisation for the following reasons:

- Smaller companies have **more room to grow**.
- Smaller companies in only one or two lines of business are easier to **understand**.
- There are **more actions** which can cause the price a small market capitalisation share to grow, including earnings growth, acquisition by a larger company, stock repurchases and a material increase in the P/E multiple.
- Numerous academic studies indicate that smaller-cap shares have provided **better returns over the long run**, even after adjusting for risk.

Trend Spotting

Wanger believes that investors should identify **long term trends** and find companies which should be able to take advantage of them. Examples are expansion of telecommunications networks, outsourcing of services or the privatisation of certain functions.

He also believes that you do not need to invest in a company which is directly “in the theme”, but also those that are “downstream” and **can benefit from them**. For example, exposure to strong growth in tourism can be gained from exposure to a car rental company.

Criteria for purchase

Wanger emphasises three particular areas:

1) Growth potential

This comes from a company's ability to exploit a long-term theme. In order to maintain growth a company must have a special niche in an area that is not entered easily by competitors. An important component of being able to maintain growth is **good management**, signs of which are:

- A focussed management team with considerable knowledge of the industry.
- The plans for the future are reasonable, and not inflexible.
- A large portion of the company's stock is owned by the managers.

2) Financial strength

To reduce the risk of investing in smaller market capitalisation companies, Wanger looks for companies with financial strength. He **avoids IPO's, start-ups, turnarounds** and companies with **high debt levels** or rising debt.

3) Fundamental value

Wanger believes that growth potential and financial strength must be accompanied by **fundamental value**. A share should be cheap relative to earnings, sales, cash flow and assets. He puts the most emphasis on the company's ability to **generate cash**.

Wanger also places a great deal of emphasis on investing in shares for the **long term,** which is often a necessity when investing in smaller companies because the trade in these shares is less prevalent.

Another sage piece of advice from Wanger is that when a share is purchased; **write down the motivating reason for the purchase**. Stocks should then be carefully monitored to assess whether the reason for purchasing is still valid. Fund managers often justify keeping a share for another reason, when the primary motivating factor is no longer valid. More often than not, the share is held for the wrong reason and the return on the share is below-average

Figure 3 summarises Wanger's approach.

Wanger's Guidelines for a Small Cap Approach

1) **Themes**
Wanger first identifies long term themes of a social, economic or technological nature. Wanger tries to find companies which have a "downstream" benefit from a trend.

2) **Size**
Wanger has a preference for smaller cap companies, but avoids micro-caps which have much higher risks.

3) **Established firms**
Wanger believes in five years of track record and avoids IPO's, start-ups, or troubled firms

4) **Strong niche position**
Companies must have a strong niche in their industry, which makes it difficult for other firms to compete. High profit margins are usually a good indicator of the ability to take advantage of a niche.

5) **Financially strong**
Wanger prefers companies that are financially strong; focussing on low debt relative to the industry average, adequate working capital and conservative accounting practices.

6) **Reasonably priced**
Investors should avoid paying too much for a share. A PEG ratio below 1 generally indicates good value.

7) **Ownership interest**
Around 20% of the shares in the company should be held by the managers.

8) **Neglected shares**
The smaller the analyst coverage for a company the more likely it is to be mis-priced.

Geraldine Weiss – Blue chip value investing, following a dividend yield approach

Geraldine Weiss is the third example of a value investor in this component. She is the editor of the highly-regarded Investment Quality Trends, a La Jolla, California-based newsletter that gives stock recommendations.

Weiss's approach is summarised by the following statement from her book: "Successful investing in the stock market is not brain surgery. **Anyone can be a successful investor**. The secret is no secret. It is simply that you confine your selections to **blue-chip stocks**, you **buy them when they are undervalued** and you **sell them when they become overvalued**. This is the well-lit path of the enlightened investor."

Weiss is firm in her view that the **dividend yield is the most effective way** of identifying an undervalued share. The dividend yield is calculated by dividing the share price by the last year's dividend and illustrates one of two things: That the company's share price is cheap, or that the company has a low dividend payout ratio (or a combination of both).

Often a high dividend yield is an indicator of a cheap share, but it might be **cheap for good fundamental reasons**. The company could, for instance, be in financial trouble or have declining prospects. Weiss takes the approach of **weeding out** the out-of-favour stocks within a relatively safe sector of high-quality stocks.

Weiss's first criteria for investment is **quality.**

The way that Weiss assesses the quality of a company is to look at the company's **history** – whether the company has withstood the test of time by **surviving a number of economic cycles** without lowering or cancelling the dividend. In Weiss's view, dividends offer the best indication of both quality and value, besides providing a source of return.

Weiss argues that accounting earnings and book value per share are both highly susceptible to distortions as a result of different accounting methodologies. Dividends, by contrast, are **not subject to any accounting interpretations** and represent an actual cash payment.

Weiss believes that this dividend-yield approach should only be applied to a pre-selected universe of shares. She lays out six criteria, of which a firm must pass at least five:

1. **Dividend increases in the five of the last 12 years**. Weiss terms this the most reliable measure of good management.

2. **Improved earnings in at least seven of the last 12 years.**

3. **The company must have paid dividends, with no interruptions, for roughly the past 25 years**. This length of measurement may be excessive, but Weiss suggests that the company must have paid dividends for a long enough term to be able to establish cycles of overvaluation and undervaluation.

4. **The stock must carry a Standard & Poor's quality ranking of no lower than A-.**

5. **A minimum of five million shares outstanding**. This ensures that there is sufficient liquidity to prevent any manipulation of the share price.

6. **Shares must be held by at least 80 institutions**. This relates to the United States. In countries with smaller investment markets, the company would qualify for this criteria if it is 'widely held" by institutions. Weiss rules this as the least rigid of her criteria.

Weiss charts a firm's dividend yield over the years and identifies the **"turning points"** at which the share price becomes overvalued our undervalued.

Weiss maintains that most stocks turn at roughly the same dividend yield each cycle; averaging those dividend yields defines the boundaries: "If a major pricing trend has ended in a 2% yield area many times, and a major declining price trend repeatedly has ended in a 5% yield area, a profile of value has been established for that stock – a 2% dividend yield identifies an historically overvalued price where the stock should be sold to preserve capital and protect profits. Conversely, when the stock is priced to yield 5%, it is historically undervalued and a good buying opportunity is at hand."

Weiss also encourages investors to look at some other basic value measures in order to **confirm valuations** derived from the dividend yield approach, including:

- A **P/E multiple that is historically low** for that particular stock and other similar stocks, and that is below the market multiple.
- A **price-to-book ratio** that is no higher than 1.3, and the closer to 1.0 the better.

Weiss also believes in a well-diversified portfolio of at least 20 shares.

Fig 4 summarises the Weiss approach.

The Geraldine Weiss Blue-Chip Value Approach

1) **Shares that qualify**

Dividends must have increased for minimum of 5 of the last 12 years

Earnings must have increased for seven of the last 12 years.

Company must have paid dividends for the last 25 years.

Standard & Poors rating of at least A-.

At least 5 million shares outstanding,

Shares must be held by at least 80 institutions.

2) **Primary criteria for selection**

Buy from blue-chip list when share is within 10% of historical level of high dividend yield.

Sell from blue-chip list when share is within 10% of historical level of low dividend yield.

3) **Factors to ensure safety of dividend**

Current assets to current liabilities of 2x

Debt to equity ratio < 50%

Payout ratios approaching 100% are a cause for concern

Dividend higher than reported earnings is a cause for concern.

References:

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Geraldine Weiss, 1988: Dividends Don't Lie: with Janet Lowe (Longman Publishing, out-of-print), and The Dividend Connection, written with son Gregory Weiss (Dearborn Financial Publishing, 1995, out-of-print)