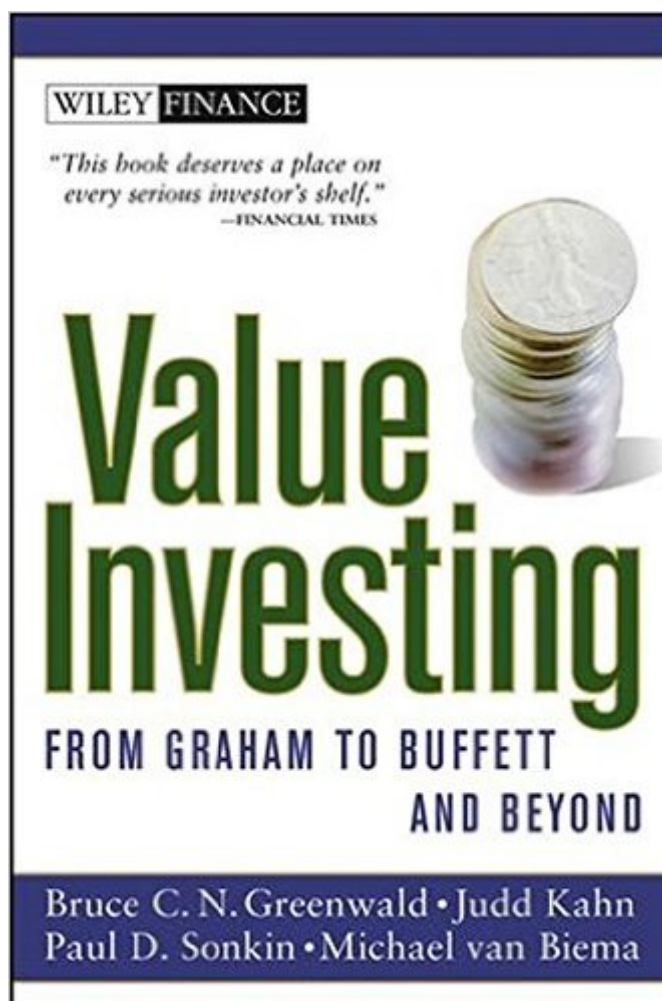


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# Value Investing: From Graham To Buffett And Beyond



## Synopsis

From the "guru to Wall Street's gurus" comes the fundamental techniques of value investing and their applications. Bruce Greenwald is one of the leading authorities on value investing. Some of the savviest people on Wall Street have taken his Columbia Business School executive education course on the subject. Now this dynamic and popular teacher, with some colleagues, reveals the fundamental principles of value investing, the one investment technique that has proven itself consistently over time. After covering general techniques of value investing, the book proceeds to illustrate their applications through profiles of Warren Buffett, Michael Price, Mario Gabellio, and other successful value investors. A number of case studies highlight the techniques in practice. Bruce C. N. Greenwald (New York, NY) is the Robert Heilbrunn Professor of Finance and Asset Management at Columbia University. Judd Kahn, PhD (New York, NY), is a member of Morningside Value Investors. Paul D. Sonkin (New York, NY) is the investment manager of the Hummingbird Value Fund. Michael van Biema (New York, NY) is an Assistant Professor at the Graduate School of Business, Columbia University.

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"No one can doubt there's an urgent need to think clearly about investing, since many investors in Silicon Valley companies have suffered a stock market decline comparable to the Crash of '29. The burned investor could find no better starting place than this superb book by four New York City value investors, all descended from the master of value investing, Benjamin Graham....They have written one of the most intelligent overviews of investing I've ever read, combining analytical rigor

with intuitive description." (DAVID A. SYLVESTER, Published Sunday, Oct. 21, 2001, in the San Jose Mercury News) "...Greenwald is an excellent guide on this subject..." (Sunday Times, 21 October, 2001) --This text refers to an out of print or unavailable edition of this title.

Individual investors in the Internet Age are blessed with information. We also are cursed with too much of the stuff, from real-time quotes to streaming videos of fund managers. This info-clutter extends to books, and cutting through it can be difficult, even dispiriting, when you see how little thought goes into so many books. That's why I've spent part of the summer doing it for you. And the new title most deserving of your time is Value Investing: From Graham to Buffett and Beyond. Its authors, Columbia Business School faculty members Bruce C.N. Greenwald and Michael Van Biema and fund managers Paul D. Sonkin and Judd Kahn, aim to place their work next to Benjamin Graham's 1950 classic, The Intelligent Investor. My 1986 edition came with Warren Buffett's endorsement--"by far the best book on investing ever written." Value Investing is better. --Robert Barker, BusinessWeek, AUGUST 13, 2001 No one can doubt there's an urgent need to think clearly about investing, since many investors in Silicon Valley companies have suffered a stock market decline comparable to the Crash of '29. The burned investor could find no better starting place than this superb book by four New York City value investors, all descended from the master of value investing, Benjamin Graham.... They have written one of the most intelligent overviews of investing I've ever read, combining analytical rigor with intuitive description." --DAVID A. SYLVESTER, San Jose Mercury News, Oct. 21, 2001 Greenwald is a conventional economist (Ph.D. from MIT) who caught the value bug. He has updated and expanded Graham's ideas, and his summer seminars (\$2,900 for two days) have become popular with everyone from well-known money managers to Columbia MBAs who couldn't get into Greenwald's class. But now there is a cheaper way to learn from Greenwald: He and three colleagues have just published "Value Investing: From Graham to Buffett and Beyond." Greenwald probably won't outsell Graham, but I think he ought to. --Paul Sturm, SmartMoney Magazine, June 19, 2001 "Whether you've been working with stocks for years or are a beginner looking for a book that goes beyond price/earnings ratios, you'll likely get something worthwhile out of the book. I certainly did." --Pat Dorsey, Morningstar, 11/7/2001 "I finally have a good solution for those wanting an updated manual on value investing. Value Investing [is] essential reading for anyone looking for a fresh perspective on analyzing companies and selecting investments. Those with a little background in finance will benefit from the book's clear prose and its profiles of eight successful value investors, and stock-market veterans will enjoy the detailed case studies in which Greenwald applies his ideas to specific companies.... It is one of

the better books on investing to hit the shelves in a while. Greenwald's detailed analysis of Intel INTC is by itself worth the price of admission, and other examples are similarly illuminating. Whether you've been working with stocks for years or are a beginner looking for a book that goes beyond price/earnings ratios, you'll likely get something worthwhile out of the book." (Secrets of Successful Investing' by Pat Dorsey, Morningstar.com) "Value Investing [is] essential reading for anyone looking for a fresh perspective on analyzing companies and selecting investments." — Pat Dorsey, Morningstar.com "Sophisticated yet accessible to people outside the orbit of business schools, Greenwald's book is a lively defense of, and handbook for, value investing, complete with glimpses of how it's practiced by pros like Warren Buffett and Mario Gabelli."

— TheStreet.com, November 15, 2001 --This text refers to an out of print or unavailable edition of this title.

This book reveals a lot about the Institutional Mentality (or what the authors call the institutional imperative- a theme carefully woven into each chapter of the book) and how the small investor can exploit its obvious and inherent weaknesses. What is the Institutional Mentality? The Institutional Mentality is a malady characterized by the following tell-tale signs and symptoms:1. The possession of a mandate that limits what you can do, specifically- what sort of outfits you can pursue as investments, how big these outfits can be, and how much money you can throw at each outfit2. The possession of a large, and often growing, pile of funds with which to invest3. The possession of a few good ideas, but not nearly enough for the amount of funds that you have available to invest4. The inability to devote time, resources and brainpower to research every nook and cranny of the market in the search for suitable ideas/investments5. The longing to look like a genius or a guru; however, this natural and important desire is checked by the greater desire to avoid looking stupid when all is said and done and performance reviews are dueThe typical treatment regimen for the Institutional Mentality is as follows:1. Actively mimic the competition in all things. So, this means that if everyone is into AAPL, you're into it, too. And if everyone is using hedging and borrowing stock to dress up year-end portfolio results, you are, too. (what Dreman calls the herd mentality and Buffett refers to as the impetus to adopt lemming-like behavior)2. Diversify- even amongst those things you know little or nothing about. This will ensure mediocrity.3. Spread funds around so as to limit potentially embarrassing losses (and on the flip-side, limit potentially lucrative, out-sized gains). This will ensure that the stated objective of investing is not achieved. (Croupiers fear not, for you will be obscenely compensated for failing your 'clients' and your fiduciary responsibility. Small investors should be very fearful, as this is the retirement money and the kids' college fund we are handling-

see the last sentence on Page 158.) Value Investing goes on to reveal the theory and practice behind one approach to investing, and the many subtle variations that a few of its more famous practitioners bring to it. It accurately details how the approach has deviated from that of The Father of Value Investing, Benjamin Graham, who sought his so-called 'net-net stocks' (stocks which are valued solely based on their balance sheets- specifically, based on their current assets less all their liabilities, current and non-current), and morphed into the various flavors as practiced by many devotees of the approach circa Y2K. Along the way, it also spends a lot of time successfully slaying the sacred cows of modern portfolio theory, discounted cash flow analysis (and the ever-present growth projections that come with it) and the elusive hunt for growth. Additionally, it also makes a good, solid case for fundamental analysis, which, oddly enough, is up-ended by the profiles of a few of the value investors profiled in-depth who basically eschew it and the one lone value investor who swears by discounted cash flow analysis- the very technique for which the authors have a dim view. In passing, the authors waited until nearly the end of the book to present their take (and an adequate and succinct one at that) on the differences between contrarian investing and value investing, something which I personally feel should have been addressed in detail at the beginning of the book. The approaches presented function best when evaluating the worth of companies that make use of tangible, physical assets to produce wealth (though they may need to make significant investments in knowledge capital beforehand via research and development and then translate that knowledge through physical capital into a tangible product). In general, I found the book lacking in specifics on how to evaluate those highly profitable outfits whose principal assets are intangibles in the form of computer code, accumulated data and other forms of knowledge capital that do not as a rule require significant investments in physical plant (and the use of associated debt capital) in order to produce wealth. In addition to covering the institutional imperative and outlining the basic underpinnings of value investing, the book also provides two thoroughly worked examples using the fundamental principles of value investing as well as profiles of a few of the leading lights- the luminaries- of value investing. These luminaries all put their own idiosyncratic spin on value investing. Some emphasize comparable sales (of assets or whole companies), while others emphasize growth within the context of an identifiable franchise. Still others focus solely on the balance sheet, while others focus on earnings power value. A couple focus squarely on negative sentiment combined with an eye on either assets or earnings, while others look for catalysts or motivated sellers (here for reasons that have little or nothing to do with the present or future prospects of the outfit). Overall, I found the book to be a very worthwhile read, considering 1) the length of time it took me to read it (almost three months), 2) how many times I had to stop and

re-read certain sections, 3) how many passages I underlined within the book, 4) the volume of notes I took when reading the book and 5) the complete, 180-degree reversal I had in my thinking and approach to investing after reading this book. I would have to say that I learned a few new tricks (and also uncovered a few new traps) while reading this book, and while I am always partial to Buffett's take on value investing (his terse words on the nature of earnings alone are priceless, and confirms everything I have been saying to folks about the market and certain stocks of late), even Buffett had to show the proper respect to Schloss & Schloss, two balance-sheet-centric value investors whom Buffett admired for achieving extraordinary results with little in the way of resources beyond a list of willing clients of modest means and a proven method, learned underneath the feet of The Master's Master, Ben Graham. Next up on my list is to read everything I can on Schloss & Schloss. Readers with an interest in the topic of value investing in practice should consult Kirk Kazanjian's *Value Investing with the Masters*, and Ronald W. Chan's *The Value Investors: Lessons from the World's Top Fund Managers*.

It's pretty rare to find a book that actually has something to say about value investing that is an improvement over the original book from Ben Graham, *The Intelligent Investor* (1934 edition). *Value Investing* delivers a good overview of the value investing approach and then also delivers hands-on practical advice about some recent innovations in equity analysis for value investors. Using the approach popularized by Ben Graham this book describes the theoretical approach and then walks through two detailed examples of how to apply the notion of enterprise value to WD-40 and Intel. With detailed analysis of financials from both companies the book demonstrates how to understand financial structures that help predict and quantify a company's competitive advantage. I've read a lot of value investing books that talk about competitive advantage, but this is the first book I've found that attempts to demonstrate directly from the balance sheet how to calculate the economics of that competitive advantage. I still want to apply everything I've read here to a dozen companies and see how well the analysis works in the real world, but the theoretical framework appears to offer a very easy way to determine who really has a franchise and then place a fair value on that advantage and establish a fair price for the stock.

A must-read for investors of any stripe, growth or value. This book, written by a couple of the most popular professors at Columbia Business School, explains the innovations in the field of value investing as practiced by some of the most successful investors in the field. (fair disclosure: I took Prof. Greenwald's courses in 2007) This book successfully bridges the gap between the traditional

Graham & Dodd style of value investing to what works today. Although it's a paperback, it's written with the density of a textbook. The writing style is not light, and the actual meat of the book takes some time to wade through. If you don't have some experience in accounting or corporate finance, then Joel Greenblatt's *The Little Book That Beats the Market* is good to read first. The substance of this book is a process for modern value investing: value investing is not investing in lousy companies just because they appear cheap. The authors also teach a structured way to value a company. Finally, the authors address how to value growth. First, before reading this book I had the mistaken impression that value investing was all about investing in the ugliest, least interesting company you could find just because it had a low P/E ratio. I was completely wrong! (Maybe I have attended too many stock pitch sessions and heard too many poultry stocks and encyclopedia companies get pitched.) Modern value investing, according to the authors: "When B. Graham went scouring financial statements looking for his net-nets, it did not concern him that he may have known little about the industry in which he found his targets. All he was concerned with were asset values and a margin of safety by that measure. A contemporary value investor had better be able to identify and understand the sources of a company's franchise and the nature of its competitive advantages. Otherwise he or she is just another punter, taking a flier rather than making an investment." What a breath of fresh air to read this passage. Second, this book lays out a structured way to value a company by first looking at reproduction costs of assets, then earnings power, and finally the value of profitable growth. I, like the authors, find traditional DCF valuations to be plagued by false precision. The authors' more practical method starts by adjusting the balance GAAP balance sheet to calculate the cost of the assets for a potential business entrant. Next, the company is valued based on the earnings generates consistently, assuming no growth. A key insight is the value of the franchise: the difference between asset value and Earnings Power Value is the value created by a company that has significant competitive advantage. Last, the value of profitable growth is considered. As a self-admitted recovering growth stock addict, I learned from this book that value investors are skeptical about growth for two reasons. One reason is that it is so hard to predict, but more important, many times growth is not worth much. Unless the return on capital (ROC) of the company is higher than the cost of capital, growth does not create value. (I am a slow learner; Greenblatt's example in *The Little Book That Beats the Market* of opening an additional gum store is even clearer to me.) The growth matrix and formulas in the book were a revelation to me. The surprising thing is how little multiple expansion a stock deserves based on growth. Unless a company truly has a franchise, expanding into other areas and "diversifying" the business often destroys value. And growth for growth's sake will not make a stock go up. This book brings value

investing into the modern stock market. Modern value investors still use traditional valuation principles in a structured way, but they also consider the value of growth and the attractiveness of the business. What a relief, I not restricted to buying typewriter and pay phone stocks! The authors quote Warren Buffett: It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price.

This is one of those books that after reading I put it on the shelf with some of the classics such as Graham's *The Intelligent Investor* and Klarman's *Margin of Safety*. Each essay is lucid and clear. Whether your new to value investing or just need to remind yourself once in a while what it's all about, you should own this book.

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