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As longtime value investors, we have noticed that there is frequently a fine line when distinguishing between stocks that provide true underlying value and stocks that are merely cheap for various reasons. Experience is often the best teacher, and through close review of both our winning and losing investments over the years, we have identified several factors which continue to play a valuable role in our investment approach and which we believe can help other investors avoid value traps and find truly valuable investment opportunities in an uncertain market. We hope you find this helpful, and welcome any feedback.

### **Value Trap #1: Price/Book**

We commonly use trailing P/E, forward P/E, P/B, and enterprise value/EBITDA to give us an indication of the relative value of a stock in comparison to a peer company or the greater market (e.g. S&P 500). The first mistake we make is using the wrong metric. P/B is relevant when you are speaking of financial services companies, REITs, or other companies with large amounts of regularly measured assets. It is largely irrelevant when it comes to technology companies or companies with large amounts of intangible assets. Book value measurements also allow for large deviations regarding intangible and inventory write-downs, making these areas to watch for value traps. Compare Intel and Apple. When it comes to inventory, Intel's products tend to become obsolete & are replaced more quickly, making their book value quite different from Apple's longer-lasting products.

Similarly, it is hard to accurately predict assets of companies that buy a large number of patents. For example, pharmaceutical companies have great risk when it comes to measuring the potential value of in-process drugs. The patent value is only measurable at the point of purchase and will fluctuate greatly with every milestone, creating substantial uncertainty throughout the R&D process and making the value of this intangible asset very hard to measure and thus hard to draw comparisons across companies or industries.

### **Value Trap #2: Price/Earnings**

P/E can be a good comparison when it comes to companies with very similar capital structures. However, companies very frequently can have low P/Es when they choose to finance heavily with debt, creating another potential value trap and making P/E a less accurate gauge of relative value. The airline industry during the financial crisis provides us with a great example of this. Delta, United, US Airways, American, and Northwest all declared bankruptcy while sporting low P/Es that were the result of high levels of debt. While they might appear to be a bargain at a superficial glance, a deeper look would show that they essentially become substantially more risky and expensive when you factor in bankruptcy risk. Southwest, which had a higher P/E, was more conservative with its use of debt and thus did not require bankruptcy protection.

### **Value Trap #3: Enterprise Value & EBITDA**

Finally, enterprise value/EBITDA takes into account all capital sources but requires greater inspection of debt structure, tax treatments (deferrals, loss carryforwards, international operations) and various methods of depreciation. In order to accurately compare different companies using this metric, adjustments would have to be made to reflect each of these factors. In the case of GE, they pay a much lower tax rate than the 35% US corporate rate, have many international subsidiaries, and have significant depreciation of industrial plant and equipment. To compare them to another industrial company of a similar scope would be costly and time-consuming. However, a consistently profitable company with operations that are predominantly in the same country can typically be used as a reasonable comparison.

### **Value Driver #1: Net Cash & Market Dynamics**

So far, the reasons not to invest have been addressed. Outside of the opposite of the aforementioned reasons, think of a company's net cash position as a great driver of intrinsic value. Think of their standing within an industry. For example, NTAP has net cash which comprises nearly half of their market cap, operates in what is essentially a duopoly market and maintains high profit margins, yet is trading at a forward P/E below 7 once you back out cash.

### **Value Driver #2: Management**

EMC was so stupid that they invested in VMWare ahead of time. Either they are much luckier than us or they have the financial flexibility to find the next big thing. I choose the latter. Every good CEO outside of Amphenol (greatest stock/run company of all-time) knows that you have to adapt. A really good friend of mine who runs an incubator company once told me, "find a CEO that can change and doesn't have an ego. Easiest way to see if a company has a shot". This approach can help the value investor identify great public companies too. Business as usual worked when Benjamin Graham was doing net working capital analysis, but is very different now. Look for financial flexibility and sustained earnings. Amazon's revenue growth and recent positive EPS have made them a market favorite with their stock price soaring accordingly over the last few years, but they will eventually be forced to justify their rich valuation, much like Apple's rapid revenue growth and stock appreciation has led many investors to no longer perceive them as a growth company with the according generous valuation multiples.

#### *Market Inefficiencies: Both a Value Trap and a Value Opportunity*

Amongst the most ridiculous platitudes I have heard in investing is "never catch a falling knife." Under this approach, no one should buy an oil company or European bank stock in this current market, regardless of any underlying value drivers. This is an attitude for market timers, not long-term investors, whom should instead use this as an opportunity to find attractive stocks (we are firm believers in keeping an active watchlist, as stocks that may be fairly or richly valued when we first evaluate them may later turn into bargain stocks due to market inefficiency) at even more attractive prices than normal. That said, there is also an importance difference that we alluded to earlier between stocks which are

value stocks trading at a cheap price and stocks that are cheap because they lack value, and we will examine several ways to determine the difference & find value rather than get caught in a value trap.

*Substantive changes in underlying fundamentals or industry structure should be taken into account*

We believe the most important step to take when a stock price falls is to determine if this is due to a long-term change in its underlying fundamentals or if it has merely fallen out of investor favor in the short-term. For the former, this should be something that forces a value investor to re-evaluate their underlying thesis, and potentially remove the stock from their portfolio or watchlist if a substantive change makes the stock now cheap for a legitimate reason without the intrinsic value that they initially thought it had. For example, is this price fall due to something like a changing political climate devastating an industry like what we have recently seen with coal and for-profit education, leading to the destruction of billions in market cap and several potential bankruptcies? Regulation is not only quite often arbitrary but also can be crippling if not fatal to an industry. Unless there is new legislation, the industry has no defense, and thus makes it difficult for value investors to determine the true intrinsic value and obtain a margin of safety. Keep this in mind once the Affordable Care Act takes full effect, especially given the large number of industries this legislation affects. Energy may be another area to watch, with political changes such as the end of Iranian oil sanctions and OPEC having large effects on the market.

*How does a value investor use market inefficiency to their advantage?*

If a stock has fallen not for any substantive underlying fundamental issue but rather due to market irrationality or fickle investors panicking, this can offer the value investor a chance to buy attractive stocks at even more attractive prices, creating a higher margin of safety. As value investors, we would not have opportunities to find attractively priced stocks if the market was entirely efficient, and taking a contrarian position when markets are fearful often leads to outsized profits - as Warren Buffett has said, "Be fearful when others are greedy, and greedy when others are fearful" (this advice can also work wonderfully for the value investor when exiting successful positions near their peak as market sentiment turns from positivity to outright greed). Listed below are a few examples of things that can cause market inefficiency, and how the savvy value investor can use these to identify attractive value investment opportunities.

*Cyclical Moves & Strong Survivors*

"Never catch a falling knife" would have caused people to miss out on huge profits in Apple, Netflix, Facebook, Chipotle (primarily growth stocks rather than value, but used as well-known, recent examples), not to mention several others in just the past few years. There are several ways to find bargains like these which offer the value investor an opportunity to purchase the stock at a compelling price. First and foremost, if the reason for a downturn is cyclical, there would be similar patterns in the past. Take a look at a graph and see if there are repeating patterns. If there is softness in the industry, such as oil right now, look at the financial situation of the company. If they have a solid cash position, still positive (while

probably reduced) earnings and can maintain dividends, the company has the opportunity to buy assets from companies in the same industry at highly discounted prices which will prove very accretive to earnings. In 2008, JP Morgan was one of the most solvent banks. When the crisis hit, they were able to acquire Bear Stearns and Washington Mutual at salvage prices. The assistance of the government also enabled them to acquire the prized assets while divesting the more toxic ones. This is a great strategy for an investor as well, and can lead to outsized returns for those with a patient, long-term view. Theoretically, one would start building a position when it is highly discounted to one's assumed intrinsic value and add with subsequent drops. Companies that survive large restructurings within their industry (for example, many airlines within the last decade) tend to emerge as much stronger entities because they are able to fill the market share vacuum created by bankruptcies and dissolutions of divisions among existing companies.

#### *Insider & Activist Sentiment*

Two other factors to consider when a stock has taken a significant fall are: who is still buying it and why is the market sentiment negative? First, check the insider purchases to see not only how much the insiders are buying but how many are adding to their existing positions. These are the people who know the company the best and theoretically have their future professional futures in doubt. If a significant number of them are willing to purchase shares in what could be dire personal financial times, it should signal a strong confidence in the company's prospects. Next, check the activist or large institutional activity. Activists take these opportunities to unlock value in undervalued assets. As they accumulate stock, they are able to create a price support while also keeping the stock in the public eye. Since value stocks can often stay dormant if they are forgotten about, this also creates a form of marketing about the underlying value that can be a very powerful catalyst. Icahn had a very successful activist campaign at Apple which did not require any significant changes in its fundamental business but a reallocation of their liquid assets. The stock went from \$400 to \$700 and has since hit an all-time high.

#### *Market Misunderstanding*

Market sentiment is another key driver of a stock in either direction. Occasionally, we find that the public or investing community has incorrectly categorized a company, which can lead to great investing opportunities. Take the example of Visa, which was trounced in the financial crisis as a company perceived to be hard hit by credit card defaults. However, banks that issued credit cards would be liable for these defaults, making the net effect on Visa far less harmful than the market assumed and creating an opportunity to obtain shares at a bargain price. Visa has the world's largest electronic payments network, which continued to bring in profit during the financial crisis. This is a great example of how the market can improperly implicate a related company into the issues surrounding the core industry, yet create an opportunity for the opportunistic long-term investor to realize outsized profits.