MOI GLOBAL

What Has Changed in (Value) Investing

This post by Dominic Fisher has been excerpted from a letter of [Thistledown Investment Management](). Dominic is an instructor at [European Investing Summit]().

My job since 1989 has been to find investments that will do better than average. My approach to this simple task began on an investment course that Hambros Bank, my first employer, sent trainees on. Day one was an introduction to the Efficient Market Hypothesis (EMH). What a blow. EMH proved my chosen career was impossible. But, a failure at my previous job of selling cable television door-to-door, I decided to read around the subject and discovered Peter Lynch, Warren Buffett and finally value investing. The idea that the stock market, because of its manic-depressive nature, offered the chance to buy parts of businesses at below their value made sense. (With a small portfolio, I had had first-hand experience of the irrationality of the market in 1987) Plus, I now had the chance to investigate businesses and to examine the motivations of other investors. I have not done anything else since.

I may be doing much the same job, but much has changed in the past 28 years. I'll highlight four things. Warren Buffett is virtually the patron saint of capitalism; fund management has employed increasingly sophisticated techniques to analyse risk and returns, passive investing (a huge boon to investors) now dominates the investment landscape, while a digital revolution makes financial data virtually free. And yet I remain committed to value investing and still think that over the life of the fund, and I hope to manage it for a very long time, this discipline will reward you and me.

Why?

I'll start with Warren Buffett and his influence on value investors. I go to quite a few conferences for value investors. The average attendee is a value manager steeped in all that WB and Charlie Munger have ever said. They intend to implement the 'value' philosophy in their field by buying high-quality businesses, with moats, high returns on capital, excellent management and opportunities to deploy extra capital ; I'll call this Buffett 2.0. These managers are usually excellent communicators and always highly educated; some may be successful. But I fear many will not as they overestimate their skill and underestimate the 'base rate' effect of investing in expensive companies. They don't believe that high starting valuations are an impediment to good returns. They will point out that if a company grows steadily at 20% then in a few years a high valuation becomes average making the investor a fortune as the growth continues.

For an example of this consider Hermes, the French luxury goods company. It has all the characteristics listed above – an ideal investment. In 2000, its share price was €44, and its PE ratio (the ratio of profits to share price) was 40 times. This valuation is much too expensive for a value investor like me. Today the price is €455, a tenfold increase. The company has managed to invest consistently, maintain high returns, and deliver outstanding share price performance – exactly the sort of investment that many 'value' investors dream of.

The problem with this is the academic evidence. This evidence shows that investing in highly valued companies produces below average returns on average; for every Hermes, plenty fail despite investor expectations. Conversely, cheap companies where investors lack enthusiasm, as a group, produce above average returns. This process does not work steadily and the last few years have been harsh on those investing in cheap companies. I think that this has led many 'value investors' to become Buffett 2.0 investors. If I am right, it leaves fewer Buffett 1.0 investors, reducing competition and giving me the confidence to continue looking for cheap companies.

The next development that I noted above was the increased sophistication of risk management and performance measurement. The intellectual horsepower deployed in this area is enormous, and the detail of risk reporting provided to clients is extraordinary. Thistledown, without the benefit of this resource, has managed to outperform the UK stock market nevertheless and done so with much lower risk as measured by volatility. This ‘low risk’ approach relies on early work in risk analysis that suggested that it is possible to reduce risk significantly with something like 20 investments. I see no reason why this work will be proved wrong and expect to continue with the diversification policies that have served the fund well for over six years.

The next topic mentioned was passive investing. I think that Jack Bogle, the father of passive investing, is the most important innovator in finance of the last 50 years. The benefit to consumers of passive investing is substantial and enduring. But, as I outlined in my *Letter to a Potential Investor*, I believe that value investing can provide a superior return. The market, for all the influence of passive investors, is driven by the emotions of its participants. Passive investing cannot alter that which means that I expect to see Mr Market behaving in his usual manner for many years to the benefit of the fund.

Finally, I mentioned that financial data is virtually free. This free data is perhaps the biggest change to the daily life of the fund manager I have witnessed. A few thousand pounds buys access to financial data on virtually every security, bond, index, fund and company director in any financial market globally. An ‘investment library’, a proud exhibit in a firm 20 years ago, is available wherever there is a computer terminal. The issue now is how to deal with the information, not how to source it. This requires a disciplined approach to data use and suits an individual or small team that knows what it is looking for. This cheap data has allowed me to make successful investments in Norway, Romania, Zimbabwe and the US, all sourced from my desk with limited input from stockbrokers or other intermediaries. Again, I see no reason to for this to change.