<u>**INVESTMENT COMMENTARY – OCTOBER/NOVEMBER 2015**</u>

Examining the "Value" in Value Investing

"Price is what you pay; value is what you get." – Warren Buffet

"In our opinion, the two approaches are joined at the hip:
Growth is always a component in the calculation of value." – Warren Buffett

"All intelligent investing is value investing – acquiring more than you are paying for.
You must value the business in order to value the stock." – Charlie Munger

We refer to the type of investing we do as fundamental, value-oriented, and businesslike. This missive will focus on "value-oriented" in the context of the value component of value investing.

Historically, investors have been grouped loosely into two camps thought to be distinct from each other: growth investors and value investors. In general and simplistic terms, growth investors are characterized by their willingness to pay higher multiples of earnings, cash flows, and book value for stocks of businesses that exhibit extraordinary growth in revenues and earnings. Value investing ties its origins to the works of Benjamin Graham whose early approach counseled investors to pay far less than the net current asset value of a business, and value investors historically are known for paying low multiples of earnings, cash flows, and book value.

This bifurcation can be seen throughout the market. Mutual fund companies market some of their funds as growth funds or value funds, but I cannot recall seeing a growth & value fund. The broad market index companies, including Russell and Standard & Poor's, have indices that focus respectively on the more growth oriented stocks and the more value oriented stocks from within the broader indices.

In our opinion, the common growth vs. value debate obscures the purpose and overarching goal of investing. We agree with the second Warren Buffett quote above that growth is a necessary component of value. We always refer to our investing style as value-oriented, and we do this to exhibit our focus on seeking value, rather than to have our style lumped into any dogmatic value investing camp.

What we mean by value-oriented reflects the first Warren Buffett quote above. We seek to pay a price for shares of stock that is less than our estimate of the per share business value of the company behind the stock. We are not beholden to buying stocks only when they have low price to earnings, price to book, or price to cash flow multiples. While "cheapness" is a component of our approach (our preferred metric to monitor is operating income yield on enterprise value), we do not buy stocks on the basis of cheapness alone.

Growth can be a significant part of our value-oriented approach to investing. The per share business value of a company will be higher undoubtedly where revenues, operating income, and free cash flows grow substantially, particularly when the runway for future growth is long. Sometimes the market recognizes this growth and prices the stock fairly in relation to per share business value. However, sometimes the market price is materially discounted from our estimate of per share business value, even in a company exhibiting significant growth. When this happens, we take advantage of the opportunity presented to us by the market to pay less for shares of stock than what we estimate they are worth. We receive more value than what we pay for it. Thus, we are value-oriented. A stock with a price to earnings ratio of 30 might scare away tried and true traditional value investors, but we find the metric alone lacking, particularly in a scenario where the metric reflects a price that we believe to be materially discounted from per share business value.

The logical follow up to the discussion above is: what is value? We agree with prevailing sentiment in the investment community and the seminal work of John Burr Williams in *The Theory of Investment Value* that per share business value is the sum of all expected cash flows generated by the business over its life, discounted to the present at an appropriate rate. In simple terms, value answers the question of what a business is worth. Compare this to price, which is what a share of stock in that business costs on the open market. We believe those numbers can absolutely be different from each other, and that markets are not wholly efficient.

In essence, the goal of valuation is to estimate the free cash a business will generate over its life and discount it back to the present day at an appropriate interest rate. Due to the time value of money, $1.00 today is worth more than $1.00 in 10 years, so all future cash flows should be discounted. In estimating current and future value, growth is a necessary and important input. Thus, growth is inherent in our value-oriented approach to investing.

We implement a two-pronged approach to investing: business analysis and valuation. As with the Charlie Munger quote above, we believe strongly that our investment operations require fundamental analysis of the business, as well as an attempt at valuing the business. Only when we conduct each form of analysis and make a decision to purchase ownership interests as a result of that analysis can we claim to be investors.

Our business analysis and valuation efforts include qualitative and quantitative methods. But the overarching goal is to determine the value of a business. That is the nature of the value that we employ in our investment operations. In order to forecast the cash flows a business will generate into the future, we need to understand the nature of the business operations, the qualitative factors or structural competitive advantages that may allow the business to earn outsize returns on invested capital and equity and to compound book value for many years into the future, the runway for revenue growth, the potential for margin expansion, and the incremental working capital and fixed investment needs.

Once we have a handle on what the business does, how it earns money, and how successful it may be in its future business operations, we can attempt to value shares in that business through various valuation methods. We utilize a number of different methods for attempting to value a business, because business value is a range of potential outcomes, rather than a precise figure. We will aim to forecast cash flows on our own using a number of estimated inputs and we will put target multiples on our estimates of earnings and cash flows based on historical and estimated returns on equity and invested capital, as well as based on peer company comparisons. We will attempt to reverse engineer the current market price to see what kind of growth and performance is implied by that price. When we are comfortable that our business analysis and valuation is sound, we will aim to pay a lower price in the market for shares in the business than what we have determined to be the per share business value.

These endeavors form the backbone of our investment operations. They are value-oriented in that they strive to determine business value. If our estimate of value is greater than the current market price, we will be interested in purchasing shares, regardless of the current level of "cheapness" or "expensiveness" as those terms are understood in common value investing parlance. We may not be value investors in the dyed in the wool, traditional sense, but we believe our value-oriented approach remains within the spirit of our forebears within the field.

As always, there are many ways to be successful in the markets, and the approach we implement on a daily basis may not be the best approach. However, we believe the operations we employ are fundamental to consistent long-term **investment** success by focusing on the discovery of value and paying less for it than what it is worth.

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