

Uses and Misuses of Ben Graham–Style Investing

By John Mihaljevic, CFA

Article Highlights

- Acceptance of discomfort can be rewarding, as equities that cause their owners discomfort frequently trade at exceptionally low valuations.
- Investors typically do the worst when they enter situations in which they lack staying power.
- A high concentration in any single deep value situation could produce a disappointing results, since some companies may miss the window of opportunity to realize satisfactory value.

Deep value investing has outperformed the market averages over long periods of time, so why wouldn't everyone with a long time horizon embrace it?



While all investors strive toward essentially the same goal—to make money in the market—their paths may differ considerably. The historical success of an approach means little if an investor cannot understand or embrace the underlying drivers of success. While Benjamin Graham is considered the father of value investing, it turns out that Benjamin Graham–style investing may be appropriate for a relatively small subset of the investment community, as it requires an unusual willingness to stand alone, persevere and look foolish. “I have learned how to suffer,” reflects Jake Rosser, managing partner of Coho Capital Management.

The Rewards of Psychological Discomfort

On more than one occasion, I have heard investors respond as follows to a deep value investment thesis: “The stock does look deeply undervalued, but I just can’t get comfortable with it.” When pressed on the reasons for passing, many investors point to the uncertainty of the situation, the likelihood of negative news flow, or simply a bad gut feeling. Most investors also find it less rewarding to reveal that they own a company that has been in the news for the wrong reasons.

Comfort can be expensive in investing. Put differently,

acceptance of discomfort can be rewarding, as equities that cause their owners discomfort frequently trade at exceptionally low valuations. If discomfort were entirely related to fundamental factors such as a company’s business prospects and intrinsic value, then little reward might exist for accepting discomfort. However, the latter seems to be at least partly due to investors’ psychological makeup. Most of us find it easier to accept a mistake if we can do so in good company. Investing in Enron and losing money may make us feel less bad because many smart people suffered the same fate. However, if we lose money in a company that has been widely panned by analysts and shorted by the smartest hedge fund managers, we may feel especially inadequate.

Consider an investment in a casualty of Apple’s (AAPL) rise to dominance—Research in Motion, Nokia, or Sony (SNE). Many analysts predicted the demise of those companies as their share prices declined. If we invested in such a company and lost money, we might feel quite lonely. Similar reasoning may apply to an investment in the much-maligned and heavily shorted for-profit education industry. Misery loves company, so it makes sense that rewards may await those willing to be miserable in solitude. Michael Mauboussin,

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former chief investment strategist of Legg Mason Capital Management and chairman of the Santa Fe Institute, observed about successful investor Warren Buffett: “Buffett’s advice is so good but so hard. The point when there’s a valuation extreme is precisely the point when the emotional pull—in the wrong direction—is strongest.” Adds James Montier, portfolio manager at GMO: “People love extrapolation and forget that cycles exist. The good news is that you get paid for doing uncomfortable things: When stocks are at trough earnings and low multiples, their implied return is high. In contrast you don’t get paid for doing things that are comfortable.” John Lambert, investment manager at GAM, seeks to generate ideas in “areas of currently depressed sentiment and hence probable low valuations.”

If we owned nothing but a portfolio of Ben Graham-style bargain equities, we may become quite uncomfortable at times, especially if the market value of the portfolio declined precipitously. We might look at the portfolio and conclude that every investment could be worth zero. After all, we may have a mediocre business run by mediocre management, with assets that could be squandered. Investing in deep value equities therefore requires faith in the law of large numbers—that historical experience of market-beating returns in deep value stocks and the fact that we own a diversified portfolio will combine to yield a satisfactory result over time. This conceptually sound view becomes seriously challenged in times of distress. By contrast, an investor in high-quality businesses that are conservatively financed and run by shareholder-friendly managements may fall back on the well-founded belief that no matter how low the stock prices of those companies fall, the businesses will survive the downturn and recover value over time.

Playing into the psychological discomfort of Graham-style equities is the tendency of such investments to exhibit strong asset value, but inferior earnings or cash flows. In a stressed situation, investors may doubt their investment theses to such an extreme

that they disregard the objectively appraised asset values. After all—the reasoning of a scared investor might go—what is an asset really worth if it produces no cash flow? Is store real estate really worth anything if the store makes no money and the entire retail industry is struggling? Bill Ackman’s investment case for J.C. Penney (JCP) [in 2010] made tremendous sense given the assumptions used in his analysis, but fearful investors may have tweaked the assumptions in such a way that little estimated value remained for the equity holders. This dynamic serves to make the stock prices of companies like J.C. Penney exceedingly volatile, providing an opportunity for investors willing to assume the discomfort of buying when everyone else seems to be selling.

Each of us knows best how much discomfort we are willing to assume in the service of superior investment returns. We should not fool ourselves, either. Investors typically do the worst when they enter situations in which they lack staying power, whether due to financial or other reasons. Plenty of money can be made in businesses that make us perfectly comfortable. The drivers of success merely shift—for example, away from a willingness to look foolish by going against the crowd toward an ability to analyze the durability of competitive advantage. Many analogies serve to illustrate this point. In real estate, money can be made both in premium beachfront property and in fixer-upper homes in middle-income neighborhoods. The skills and sensibilities of the people profiting in these distinct areas differ markedly. The people who tend to succeed seem able to match their strengths to the requirements of the opportunities they pursue.

Not a Low-Turnover, Long-Term-Oriented Investment Approach

Graham-style deep value investing might be called the original value investing. Yet it is somewhat incongruent with a key trait of many value investors: patience, exhibited by low portfolio turnover. When we invest in

an asset-rich but low-returning business, time may be working against us. As long as management can hold on to the assets and keep reinvesting capital in the business at low returns, shareholders may earn unimpressive returns despite a bargain purchase price. Warren Buffett once described the Graham approach as walking down the street and picking up cigar butts. They are kind of soggy and repulsive, but we do get a free puff out of them. Cigar-butt stocks are meant to be one-time hits, delivering a non-recurring return—and hopefully doing so quite quickly. No one wants to be stuck with a soggy cigar butt.

Some confusion exists among investors because many regard deep value investors as the ultimate patient investors, willing to operate in obscurity and invest in companies that may go on for months with little or no news. Less patience seems to be required to invest in high-flying stock market darlings due to busy news feeds, ample Wall Street analyst coverage and lively online discussion. Cigar-butt stocks may indeed require a greater willingness to stick around than do highly liquid market leaders. However, the nature of cigar butts implies that success in this area is likely to come with material portfolio turnover, perhaps on the order of 100%. If we assume that a deep value portfolio turns over once annually, the investor can still realize a long-term capital gain for tax purposes. However, the investor will not benefit from an ability to build up a large deferred tax liability over time.

By contrast, investors who seek out value but do so in businesses with attractive reinvestment opportunities may remain invested in the same companies for many years, reaping the benefits of tax-deferred compounding. Rosser describes his evolution toward higher-quality businesses:

“Net nets [companies valued only on their net current assets] and sum-of-the-parts opportunities were previously part of our toolkit but have since been thrown out. We still endeavor to own companies with strong balance sheets, but we are much more interested in companies that possess an earnings engine

that does not need fixing. Ultimately, the reward on such companies is an order of magnitude greater than what can be earned on closing the valuation gap on a company trading for less than its liquidation value. In short, we have migrated from the Ben Graham cigar-butt approach—focused on closing the gap to intrinsic value—to the Charlie Munger approach—focused on the purchase of compounding machines at a slight discount.”

Ultimately, both Buffett-style and Graham-style investors can make money in the market. Key considerations include an investor’s personal preference for the kind of security analysis needed for each style and the discipline needed to apply the chosen approach consistently. Perhaps this is why many investors either adopt an approach and stick with it or evolve from one approach to the other. Few investors apply both approaches successfully at the same time in the same investment vehicle.

Ben Graham-style investing shows that a buy-and-hold approach to investing is not always a virtue. When we attempt to extract value from poor businesses with valuable assets, impatience becomes a virtue. We are not referring to impatience with the stock price—quite to the contrary. If our analysis is correct, stock price declines would move us closer to buying more shares rather than selling the investment. Instead, we refer to impatience with regard to the course of the business itself.

For most investors, this represents a theoretical exercise, except perhaps for the occasions when they withhold

votes from management to express displeasure. This is why many of us look for situations in which an activist shareholder may have already entered the fray. We see promise that our impatience may actually be acted upon by a resourceful fellow shareholder. If the activist’s method for catalyzing action is a proxy fight, the votes of more passive but equally concerned shareholders may become crucial.

If we assume that the passage of time usually diminishes the annualized return shareholders can expect from a cigar-butt stock, then the question arises

whether a mechanical turnover rule makes sense. If a company has done nothing to realize shareholder value over a year or two, should we sell the stock to avoid getting trapped? I would advise against such a rigid rule, as every removal of discretion also removes an option from us—an option to do the right thing under the circumstances. As a result, I may advocate for a thesis review session at regular intervals, but I would not automatically sell a security simply because of the passage of time.

In an annual or quarterly thesis review session, I may focus on how

Suggestions for Finding Graham-Style Stocks

In his book, “The Manual of Ideas,” John Mihaljevic offers suggestions on screening for stocks trading at a discount to their net current asset values. A strict Graham approach is more stringent than merely seeking stocks trading at discounts to book value because it ignores long-term assets.

Consider the Actual Assets

According to Mihaljevic, Marty Whitman of hedge fund Third Avenue Asset Management uses corporate disclosures to distinguish between assets. Whitman seeks to adjust assets to reflect their economic reality, such as by recognizing how marketable they are. For example, a higher-end office building in Manhattan can be easier to sell at market value than the inventory of a failing retailer. As such, Mihaljevic says “enterprising investors” may benefit from making commonsense adjustments to the balance sheet.

Determine if Buybacks Are Creating Value

Companies can boost tangible book value by using free cash flow to buy back stock. As long as the shares are repurchased below book value, it will become exceedingly difficult for the stock price to decrease, according to Mihaljevic. He warns, however, of not having buybacks occur at prices above a company’s intrinsic (fair) value. Purchases made at a premium will destroy value since the company is spending more in cash than it is receiving in value.

Insider Trades Can Be a Positive

Insider buying can send a strong signal, especially since corporate insiders face a higher emotional hurdle in buying a pessimistic stock. Mihaljevic views insider purchases of an underperforming stock as a sign that insiders believe the market has overreacted. He adds that “even a modestly optimistic outlook may top the market’s expectations in the case of a Graham-style bargain.”

Declining Sales May Provide Upside

If a business encounters tough conditions or enters a permanent period of stagnation, the amount of capital needed to operate the business will be reduced. This will, for a period of time, free up cash for other uses and result in a high free cash flow yield (free cash per share divided by the stock’s price). In such cases, management can increase the value of the business by returning cash to shareholders instead of attempting to reignite growth by reinvesting in the company. The caveat is an evaporation of sales which, in turn, will eventually erode the company’s capital base.

AAI's Graham NCAV Screen

Users of AAI's *Stock Investor Pro* fundamental stock screening and research database program have access to the Graham NCAV screen. This screen identifies stocks trading at a discount to net current asset value (NCAV), which is commonly defined as:

$$\text{current assets} - (\text{total liabilities} + \text{preferred stock})$$

The screen caps the valuation of passing stocks at to no higher than two-thirds of net current asset value per share. Passing companies must also be profitable and have positive cash from operations for the past four reported quarters. In addition, leverage must be at a reasonable level, with total liabilities accounting for no more than 50% of total assets.

See this issue's First Cut on page 6 for a simplified version of this screen.

Marc Andreessen argued that "software is eating the world." It's difficult to argue against Marc's conclusions, and denial is never a recipe for success, whether in investing or in life. If we accept that creative destruction will continue at least at the pace experienced throughout recent history, then it becomes obvious that businesses trading at deep value prices are likely to be among those that are creatively

Finally, investors who like to hedge their exposure to specific companies or industries may find it difficult to do so with cigar butts. Value creation in a deep value investment will typically correlate rather modestly with value creation in the related industry. When Kmart was working its way through bankruptcy, comparable-store sales trends at Wal-Mart Stores (WMT) and Target Corp. (TGT) bore little correlation to the value Kmart's creditors were likely to extract. When Circuit City was struggling to stay out of bankruptcy, Best Buy's (BBY) sales trends should have been all but irrelevant to Circuit City shareholders. To the extent that Best Buy was taking market share from Circuit City, value creation at the two companies may even have been negatively correlated. Sometimes, value in a Graham-style situation will reside at the periphery or outside the industry in which the core business operates. In the case of Kmart, most of the value derived from store real estate rather than the retail business itself. These factors make it exceedingly difficult to hedge most deep value investments by short-selling equities in the same industry.

Another popular hedging technique—the purchase of put options [the right to sell stock at a specified amount by a certain date]—also faces serious hurdles in the land of cigar butts. Deep value equities tend to have smaller market values, both because they are cheap and, more importantly, because if they were larger more investors would analyze them, perhaps rendering them less undervalued. Due to the below-average market capitalization of Ben Graham-style bargains, no functioning options market may exist in individual securities. In cases in which options are available at acceptable bid-ask spreads, the options premium may be prohibitively large because of high implied volatility. The stock prices of many Graham-style bargains have declined precipitously, heightening historical volatility. Greater investor awareness of the likelihood of future strategic actions may also increase the volatility option writers will assume in their

(continued on page 21)

reality has played out in relation to my original investment thesis. If needed management actions have been slower than expected, I want to understand why. Most importantly, I need to incorporate whatever experience I have had with a particular situation into a judgment about the likely future course of value creation in the same situation. If I still expect satisfactory value creation from this point forward, then it makes sense to remain invested. The past is like a sunk cost—it should not figure into our assessment of the expected investment return, except to the extent that it helps us better anticipate the future course of events.

Beware of Portfolio Concentration in the Land of Cigar Butts

Creative destruction remains alive and well in the global economy. Some would even argue that the pace of change has accelerated, creating additional peril for many businesses. Newspapers and television networks were considered some of the most predictable businesses for many decades, but the advent of the internet has put their future in serious jeopardy. In an insightful August 20, 2011, editorial in *The Wall Street Journal*, internet pioneer turned venture capitalist

destroyed. How quickly and comprehensively the intrinsic value of a weak business franchise may be destroyed is a tough call. It seems unwise to allocate a large portion of investable capital to any one deep value opportunity, even if it promises a large expected return.

Another argument against portfolio concentration lies in the nature of value creation in deep value situations. Strategic actions rather than skilled operation of the core business typically unlock value for shareholders of cigar-butt equities. It is usually more difficult to extrapolate future strategic events from recent actions than it is to extrapolate future operating performance from recent results. Even in situations in which management has credibly articulated a path of strategic value creation, the timing and value realization of future events remain highly variable. Sometimes companies have a window of opportunity to realize satisfactory value. If they miss this window, value destruction can be swift. Think of asset-rich, but cash-poor companies that may need to sell assets before an approaching creditor deadline. As a result of the unpredictability inherent in strategic events, high concentration in any single deep value situation could produce a disappointing result at the portfolio level.

So it's really about discipline on those types of metrics.

The last one is capacity: You just can't manage a lot of money in the space. With our two strategies, we have a capacity of a little less than a \$1 billion.

We've actually closed our strategies to new investors four times since inception just to prevent them from getting too big in terms of asset size.

CR: *For individual investors who are trying to buy micro-cap stocks, do you have any general guidelines they should keep in mind?*

MC: It's really like most investments: Practicing discipline, focusing on the longer term and also understanding diversification. I think you can get away

with less than 80 to 120 stocks in your portfolio if you are an individual investor, but you really need to have a lot of names within your portfolio.

You can go through an extended period of time where a name isn't working and then you wake up and it works in a big way, or vice versa. That happens, and it's pretty difficult to have perfect timing with any investment, particularly in this space.

CR: *In terms of buying and selling, any suggestions on placing trade orders or how it should be reviewed?*

MC: Limit orders are always great with any investment, particularly with the micro caps. If you're trying to put

a fair amount to work, even if it's only 5,000 shares, you should use limit orders.

CR: *Okay great. Anything I haven't asked you that I should?*

MC: No, I think you covered it. I love the micro-cap world, which is why I made it my career. I also think all investors should have at least a small amount allocated to micro-cap stocks. ▲

Go to AAII.com for more of this interview and to hear bonus audio from Charles' interview with Michael Corbett about broken IPOs whose market capitalizations have fallen down in the micro-cap category, as well as the investing lessons he's learned.

Michael Corbett is CIO and portfolio manager for all equity portfolios with Perritt Capital Management and The Perritt Funds. Find out more at www.aaii.com/authors/michael-corbett. Charles Rotblut is a vice president at AAIL and editor of the AAIL Journal. Follow him on Twitter at twitter.com/CharlesRAAIL.

(continued from page 16)

pricing models. Finally, put options in fearful stocks tend to be quite expensive due to many investors' desire to hedge their losing positions. Occasionally, short sellers [those selling stock not owned]

become quite aggressive in declining equities, making the outright short sale of stock expensive. When short sellers are forced to incur a negative rebate due to low availability of borrowed shares, they may resort to buying put options

instead, making the latter too expensive for most value-oriented investors. As a result, hedging may become impractical, forcing investors to size their unhedged positions in a way that does not endanger the portfolio. ▲

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