A brief history of value investing

Benjamin Graham, widely considered the father of value investing, made his reputation and fortune by purchasing shares of solid businesses whose stock prices were trading at bargain levels. A patient investor, Graham held such stocks until the broader market recognized the unpolished gems he accumulated.

He shared details of his investment approach in a number of books – such as Security Analysis (published in 1934) and The Intelligent Investor (first published in 1949) – that have become cornerstones for the investment industry. Concurrent with a distinguished career on Wall Street, Graham taught at Columbia University in New York City.

Graham’s successful tactics are based on a thorough understanding of two key elements:

- Company fundamentals
- Market behaviour

Graham believed that successful investors need to understand the difference between a company’s underlying value and its stock price. Such an understanding could only be acquired from in-depth analysis of business fundamentals such as cash flows, debt levels, and profit margins. But he also realized that investors need ‘the proper mental and emotional attitudes toward their investment decisions’.

He knew that most investors, even if armed with the necessary facts to make reasonable decisions, would fail because of their inability to keep their emotions in check. In fact, he wrote, ‘the investor’s chief problem – and even his worst enemy – is likely to be himself’.

Graham understood quirks of human nature as they related to investing – namely, the desire to follow the herd, the tendency to be overly optimistic about popular stocks, and the general disdain for stocks that aren’t glamorous or fashionable.

By melding a counter-intuitive approach, fundamental company analysis, courage, and discipline, he created an enviable formula for success.

Historical performance

The notion of buying unpopular stocks – those with discernible value but selling at deep discounts because they are out of favour – and holding them until the broader market recognizes their underlying worth is how people often think of ‘value’ investing.

Many believe value investing is a defensive tactic, a strategy used to weather bear markets, an approach that will protect against steep losses – but won’t provide much in terms of long-term gains. However, from a historical perspective, returns for value stocks have been exceptional – and have been achieved with limited risk.

High returns and low risk? Sounds improbable, however, not for long-term investors. The value style has enjoyed higher long-term returns and, at the same time, substantially less short-term volatility.
What value investors believe

Aware of the human tendencies for ‘bias’ and ‘misjudgement’, value investors are conservative in several fundamental ways. They attempt to distinguish between ‘investing’ and ‘speculating’. They usually stay within their ‘circle of competence,’ avoiding investments in businesses with sketchy prospects or obscure balance sheets. They do not rely heavily on forecasts of sales or earnings to derive their valuations. Most stress preservation of capital and strict valuation standards. They generally reserve a ‘margin of safety’ in their pricing to provide a buffer against price declines that could result from negative surprises. Value investors tend to focus on using most effectively what they do know, not guessing or speculating on what they don’t.

In addition, value investors typically emphasize the importance of paying the ‘right price’ – a low price – for a business. To determine the right price, they look internally to the financial performance of the business, paying relatively little attention to external factors such as market trends or macro-economic factors. Thus, most value investors tend to purchase equity investments at prices that are low relative to earnings, sales, book assets, cash flow, or some other specialized measure of value.

Finally, because they believe patience is necessary to obtain good results, value investors have a decidedly long-term investment horizon. They believe that the low prices they pay for their investments are the result of a temporary disparity between the fair value of the business and its current market price. Inevitably, the gap between price and fair value will close, creating an opportunity for profit. As such, value investors typically travel against the grain, countering the over-reactive tendencies of the majority by investing heavily in stocks that are undervalued while limiting exposure to stocks that are overpriced.

In closing

We believe long-term investors typically share three primary objectives:

- Capital appreciation
- Capital preservation in declining markets
- Superior long-term results

Based on historical evidence for value stocks that spans more than seven decades, value investing has been able to deliver each of these benefits. The evidence is clear – over the long term, value investing has delivered superior results with less risk.

With its emphasis on purchasing solid businesses at discounted prices and taking advantage of human behavioural quirks, we believe value investing remains the most fundamentally sound approach for generating and preserving wealth. These results are consistent with the view that disciplined value investors are able to bypass some of the more widespread cognitive biases, giving them an edge over their more conventional competitors.

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