The Art of Value Investing

David Nawrocki, Villanova University

ABSTRACT

This paper presents an idea for a non-traditional course in investment management. We had access to a large number of speakers who could come in during the semester and provide insight into how they managed investment portfolios. As we started out, we thought we would be focusing on value investing but found out through our speakers that there are many different approaches to investment management. The class ended up as an overview of investment management.

INTRODUCTION

This paper presents an idea for a non-traditional course in investment management. While originally structured as a course in value investment, we found that there were many types of investment management. The course included topics such as value analysis of financial statements, international investment, special situations, hedge funds, investment management for individuals, micro caps, small caps, community banks, boards of directors, analysis of corporate managers, fixed income, risk management, corporate acquisitions, and leasing of coal reserves.

The class met once a week in the evening and lasted for three hours. Each week we would have a practitioner talk about his/her investment management process for the first half of the class. For the second half of the class, students would present a stock analysis of a company and answer questions from the practitioners in the room. Student grades were based on three stock analysis presentations during the semester plus a written essay final exam.

We quickly discovered that we had speakers from different investment viewpoints. Figure 1 provides an overview as we had investors who were microfundamentalists as well as macrofundamentalists. We also found out that the different academic approach by business schools provides a difference. Traditionally, we think of the Harvard business case approach and the Chicago analytic approach as two approaches taught by business schools. When we look at the microfundamentalists, we see the two approaches with the Harvard business case approach followed by value investors and the Chicago analytic approach being followed by growth investors. The business case approach stresses the current value of the company and will not make the assumptions required to do a present value of expected free cash flows of the company. The analytic approach is going to perform present value of expected free cash flows of the company. To me, the difference between a value and growth investor is the time frame. The value investor is willing to wait years until he/she is able to realize the value in the company. A growth investor needs to realize value in a relatively short period of time as companies move through their product life cycle (See Figure 2). Because of shorter time horizons, growth investors are able to use present value analysis on fewer cash flows, thereby, making fewer assumptions.

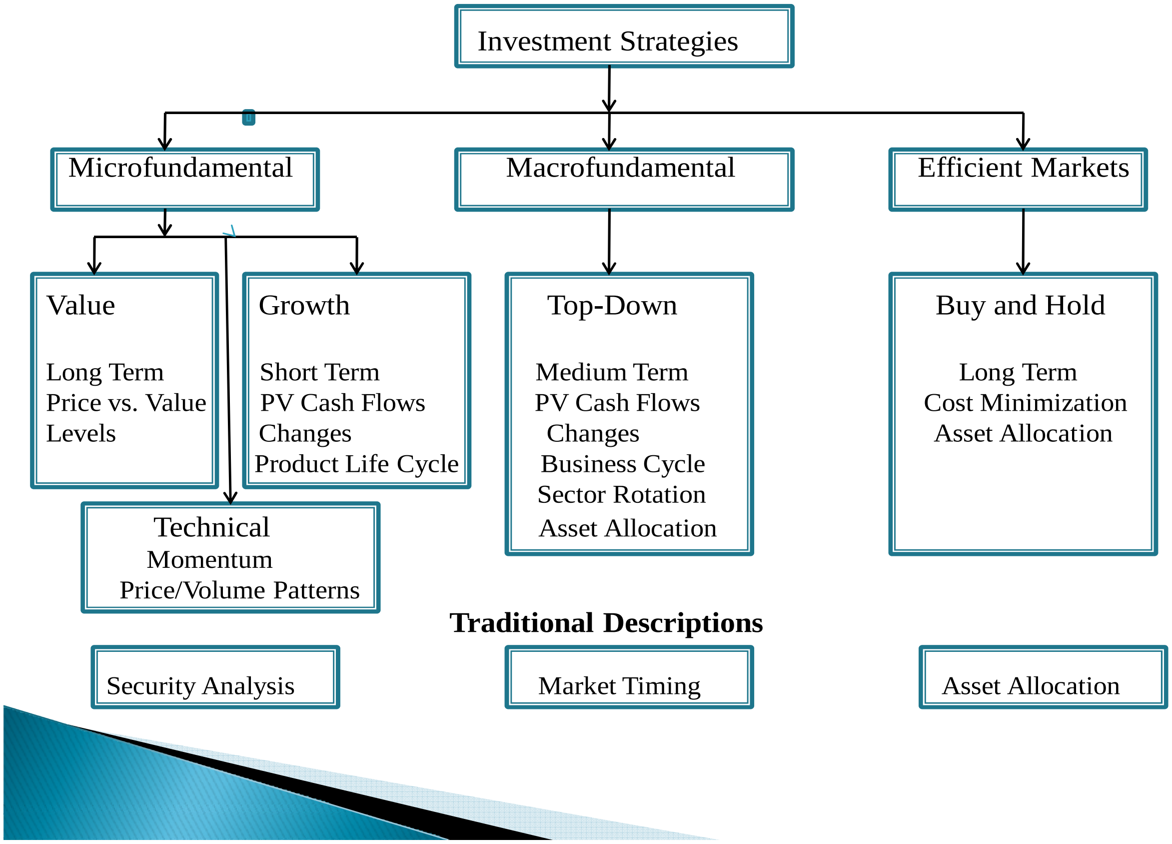

Figure 1 – An overview of investment management processes based on Greenwald, Kahn, Sorkin and van Biema (2004)

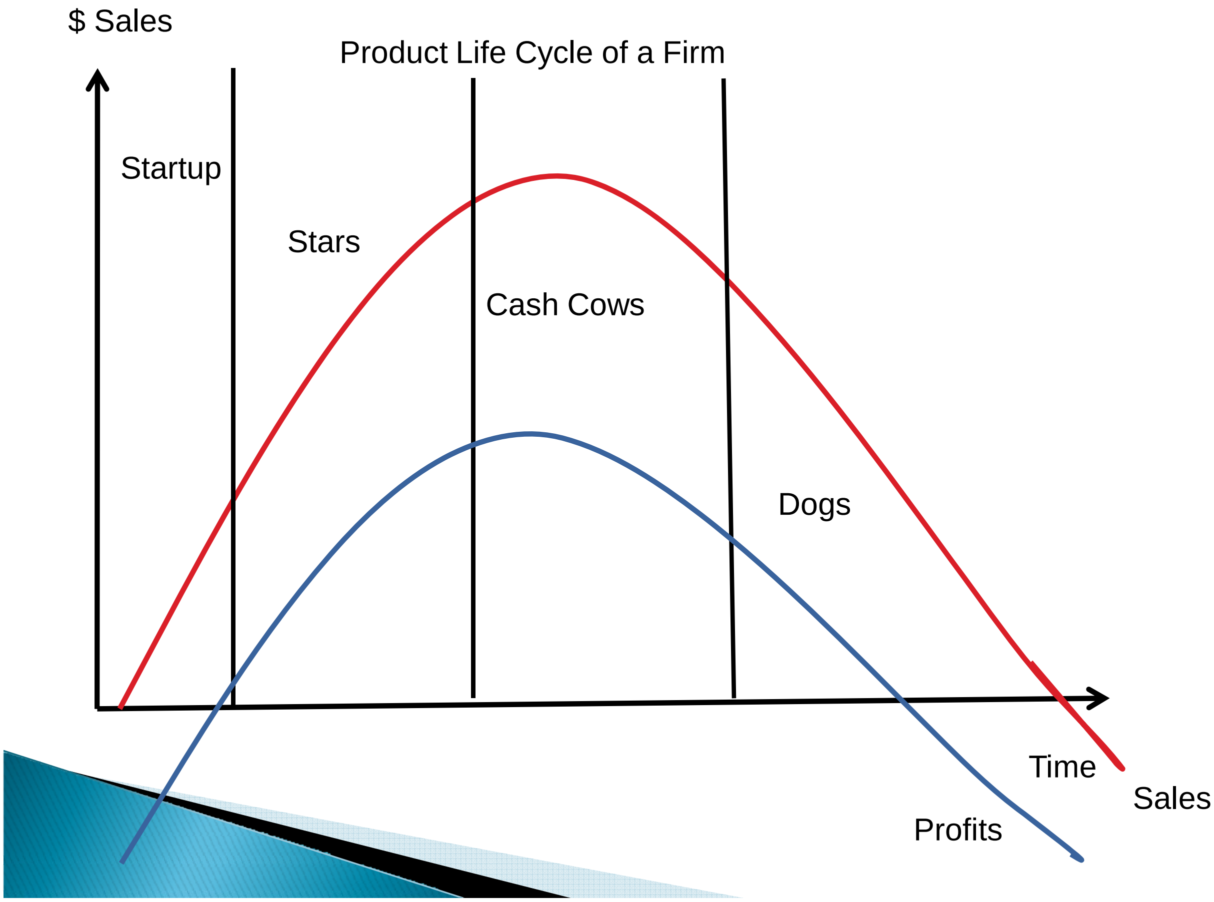

Figure 2 – The Firm and the Product Life Cycle

The macrofundamental approach is the traditional top-down investment management and is an intermediate term approach where the investor is looking at the effect that the business cycle has on investment returns. As the average business cycle is around four years, the top-down investor is concerned with which sectors will perform well during the stages of the business cycle. Figure 3 provides a view of the different stages of the business cycle. This approach is known as sector rotation as the investment manager will rotate the portfolio through different sectors as the economy moves through the business cycle. The top-down derives its name from the fact that the investor starts with an analysis of the business cycle, decides where the economy is within the cycle and then decides which sectors will perform well during this stage. At this point, we run into another name for the macrofundamentalist which is "relative value". Once the manager decides on which sectors will perform well, each industry (within the sector) will be analyzed to find the best stocks within the industry. Usually, the analyst will be looking for the best value in the industry "relative" to other companies in the industry.

While this approach is sometimes called market timing, the portfolio manager rarely attempts to "time the market" but rather tries figure out where we are in the business cycle and rotates funds into sectors expected to do well during that phase.

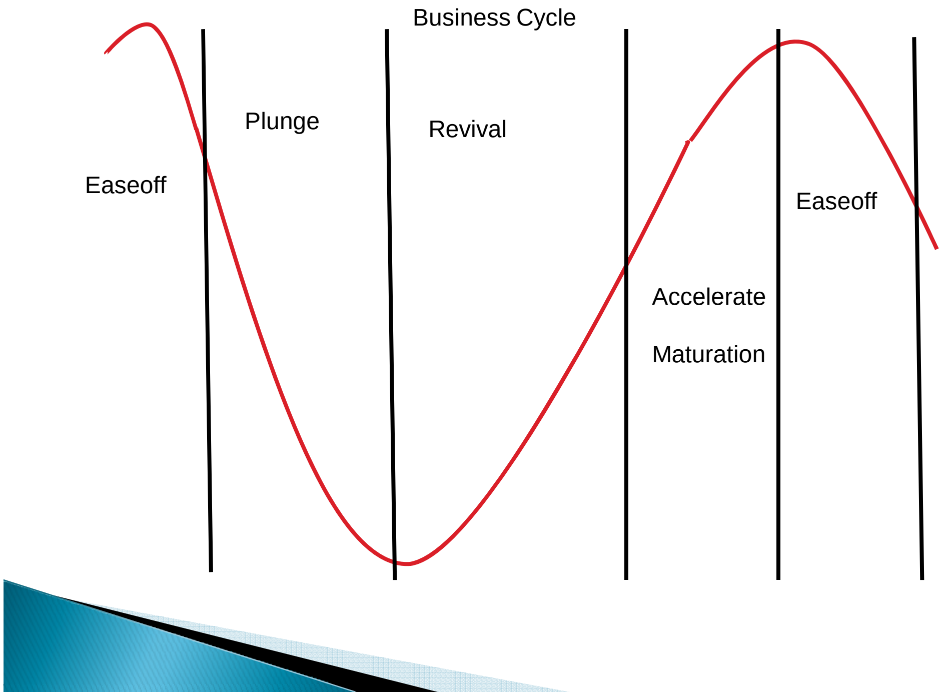

Figure 3 – Phases of the Business Cycle

Because of the shorter time horizons inherent in the phases of the business cycle, security analysis in this approach tends to use the present value of expected free cash flows for the firm. Overall, this approach is a Chicago analytic approach.

The final approach is the efficient market approach which recommends well diversified portfolios held for long periods of time. It is a long-term investment horizon approach like the value microfundamentalist approach but does not stress individual security analysis. Instead, the focus is on diversification and asset allocation.

As a result, our speakers for the semester broke down into value and growth microfundamentalists and the top-down macrofundamentalists. A list of investment topics and the investment approach covered during the semester are presented in Table 1.

Table 1 – Overview of Speaker Topics

I. **Value Microfundamental Approach**

Case Study – Pepsi Bottling
Case Study – Maher Terminals
Case Study – Verisign
Investment in Community Banks – Case Studies
Qualitative Analysis of Companies – Management – Board of Directors
Special Situations
Corporate Acquisitions – Seneca Foods
Constructing a Value Portfolio using Net-Net

II. **Growth Microfundamental Approach**

Small Cap Growth Stocks

III. **Macrofundamental Approach**

Top-Down Investment
Fixed Income, Money Market Funds and Risk Management
International Investment

SOME FEATURES OF THE CLASS

The class is non-traditional because the faculty member is doing very little in terms of traditional lecture and note-taking. Most of the class time is taken up by the outside speakers and the student presentations of a stock. The class is structured so that each student is involved in three stock presentations. On any given night, there will be 4-5 practitioners in the audience, usually the speaker and a few local practitioners who are interested in listening to the speaker. Therefore, the students are presenting to practitioners. A common theme from the practitioners is that ***successful investment analysts have to provide their own structure for their analysis***. They would be the swim instructor that throws students in the pool and tells them to swim. Their point is that is how Wall Street trains analysts and students should learn to provide structure while they are in school.

We tell students that if they present and there are no comments or questions from the practitioners, then they have essentially failed. If they can get the practitioners to engage in questions and discussions about the stock, then they have done the job.

BENEFITS

During the semester, students improved on their oral presentation skills. As they saw case presentations by practitioners and had their own stock presentations carved up by the practitioners, they learned to improve their stock analysis skills. Each week of the class, the student presentations improved from the previous week.

Students learned that a pure Chicago analytic approach where they simply plugged numbers into equations and generated a target stock price didn't sit well with the practitioners. They had all of their assumptions and calculations questioned. By the end of the semester, students were relying less on simple assumptions and could justify any assumption that went into their analysis.

DRAWBACKS

Villanova students hate the lack of structure. They feel that the instructors' job is to provide structure in their learning environment. Even though they handled the lack of structure and showed constant improvement during the semester, don't expect any favors at the course evaluation time.

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