Thought Piece

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Value Investing, Redefined

Morgan Housel wrote that everyone belongs to a tribe and underestimates how influential that tribe is on their thinking.

- People are drawn to tribes because there's comfort in knowing others understand your background and goals.
- Tribes reduce the ability to challenge ideas or diversify your views because no one wants to lose the support of the tribe.
- Tribes are effective at promoting views that aren't analytical or rational, and people loyal to their tribes are poor at realizing it.

Value investing is a tribe, and as Housel points out, tribal thinking can suppress new ideas. Dogma is another word for tribal thinking, and value investing is the ultimate dogma. And dogmas harden. Buy low P/E stocks, and avoid technology. After all, Warren says so. The curmudgeonly, reflexively contrarian "value" investor who thinks everything consensus is a scam and his 0.5X book value timber company is a safe bet, is a meme that perfectly encapsulates the dogma of the value tribe. But that thinking is not working, and it hasn't worked for a long time.

So how did we get there?

"In the beginning, there was nothing. No data, no information, no charts."

In the beginning, there was nothing. No data, no information, no charts. At least nothing you could easily get hold of. Stocks were seen as gambles, and bonds were the only investment fit for purpose. Graham and Dodd came along and exploded that dogma. In 1934, "Security Analysis" was published. It's central insight was that equities could be safe investments. You just had to go to the effort of getting information and then buying stocks that were really cheap. No one was doing this. The revolutionary metrics of the day were low P/E and low P/B. The story of a young Buffett walking from farm to farm to buy stocks at a P/E of 1 from people who were just too happy to get a few dollars for their pieces of paper typified the edge that a little bit of information and some hard work conveyed.

Thirty years later, everyone had become a value investing stock picker and cheap stocks were rare. Buffett closed down his investment partnership, and the nifty-fifty growth stock craze took off. When these collapsed, it lead to a hardening of the value dogma. "See, you just don't pay up for growth!"

Charlie Munger came along and exploded that dogma. He convinced Buffett to kick his cigar butt habit, and buy growth companies. Mungers' central insight was that certain businesses had sustainable barriers to entry, and could reasonably be expected to grow profits at a high rate for a long time. You could hold these stocks forever, and make a lot of money doing so. No one was doing this, and the revolutionary metrics were "moat" and RoE. Fifty years later, Berkshire Hathaway still has a big position in Coca-Cola shares.

"By the turn of the century, everyone was investing in growth stocks, and buying cheap stocks was out of favour."

By the turn of the century, everyone was investing in growth stocks, and buying cheap stocks was out of favour. Internet-related growth stocks took off. When these collapsed, Munger and Buffett looked like heroes, saying "tech is too hard to invest in". As a result. attitudes hardened - you could buy growth, as long as it wasn't technology-related.

Nick Sleep and Qais Zakaria came along and exploded that dogma. They set out their thinking in a letter to their investors about how "the benefits of scale, shared" made Costco dirt cheap. At the time, it was trading on a P/E of 35 and had no discernible moat. Since then it has been a ten-bagger, compounding at over 20% p.a. I understand that at some stage later on, Amazon and Apple made up over half of their portfolio.

"Growth and value are two sides of the same coin."

"Scale Benefits Shared" was their central insight, and most value investors - including myself - missed that boat. Our attitudes towards tech had become hardened. Historically, many of the great bonanzas for value investors came in periods of panic following the bursting of bubbles. This has probably lead to scepticism of market exuberance, especially concerning companies whose assets are intangible.

But this scepticism, based on mean reversion - a natural state of the value investing tribe - can lead to knee-jerk dismissiveness. A dismissiveness that resulted in value investors not investing in internet-enabled businesses benefiting from increased scale. Companies like Apple, Amazon and the other FANG stocks have produced fantastic returns for those very few value investors who understood what was happening.

Given this history, what principles can we rely on today?

"That which creates 'undervalued assets' has not changed."

Firstly, growth and value are two sides of the same coin. They are not mutually exclusive, and should never be seen that way.

Secondly, what is valuable is that which does not change. And that which creates "undervalued assets" has not changed. These include, but are not limited to:

- Extrapolating depressed conditions
- Underestimating future potential
- Forced selling and neglect due to negative emotions or leverage
- Early recognition of valuable business models

Thirdly, the capital cycle: high returns attract investment, reducing prospective returns. Poor returns reduce investment, increasing prospective returns.

Finally, scarcity is valuable. Fishing where the fish are implies navigating uncharted waters, where few others dare to fish. Graham and Dodd did so when buying cheap stocks, Buffett and Munger did so when buying growth stocks and Sleep and Zakariah did so when buying tech stocks.

"Keeping an open mind and avoiding dogmatic tribal thinking, will be key."

Fortunately, if the value investors of today consistently apply these principles, opportunities will continue to present themselves. However, keeping an open mind and avoiding dogmatic, tribal thinking will be key.

David Deutsch summed it up well when he said: In all domains, we are searching for the best explanation and that explanation represents reality in some way but it's never the final thing, and that's a good thing because it means we can go on forever making progress.

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