Note to readers

Learning the principles, history, and methods of investing and investors is important, but only by **practicing the craft** will you improve. When you understand the theory of flight—that differential air pressure over the plane's wings—creates lift, will you be able to push the nose of the aircraft towards the earth when the plane begins to stall. That is the opposite of your natural reaction. For example, when Buffett speaks about the dangers of unprofitable growth, you might wonder, "How do I value growth or determine whether a company can grow profitably? This handbook in other chapters will have information on valuing growth. So, you can skip these sections and move onto those particular case studies. But you should come back to understand the principles and concepts of investing.

Ultimately, your goal will be to articulate in a clear and focused way your **search** strategy, a well-defined and consistently applied process for **research** and **analysis** within your **circle of competence** to determine **value**. You will follow a discipline for buying, for selling, for diversification, and for managing risk. Finally, you will meticulously track your progress both analyzing your successes and mistakes as well as others'. You can argue why you will be able to outperform by implementing your investment approach. This handbook with its links to original sources will assist you in building YOUR own investment philosophy.

CHAPTER 1: WHAT IS INVESTING?

You take a dollar out of your pocket to buy either a stock (equity investment) or bond (debt or loan) then you receive dividends or interest payments until you sell that stock or bond (or the bond's principal is repaid). Then after-taxes, you have a dollar(s) that you hope you can exchange for at least as many goods and services as when you made your investment. Of course, because of time preference, you will always prefer one dollar today versus one dollar a year from now.

Since you start with a dollar and end with a dollar(s), the question you must ask is, **"What is money?"**

The Austrian economist, Ludwig von Mises, explained why certain commodities become the widely accepted means of exchange, i.e., money. It is the most marketable good which people accept because they want to offer it later in acts of impersonal exchange (Human Action , p. 398). Certain goods, like precious metals, became the most marketable thus becoming money. Money is both a medium of exchange and a store of value. You might hold some money balances for unforeseen needs in the future.

Money transmits value, Mises taught, but money does **not** measure value. Money exchanges for other goods in certain exchange ratios. Mises also said there is **no measure of economic value**. He was a disciple of Carl Menger who was a proponent of a strictly subjective theory of economic value.

An exchange is not based on someone's measure of value, merely his comparison of value: more vs. less. Mises said, "The judgment, 'Commodity a is worth more to me than commodity b' no more presupposes a measure of economic value than the judgment (A is dearer to me—more highly esteemed–than B) presupposes a measure of friendship (Theory of Money and Credit, pp. 44-45). This means that "There is no such thing as abstract value" (p.47). There are only **specific acts** of valuation.

Money does measure objective prices (ratios of exchange). "If in this sense we wish to attribute to money the function of being a **measure of prices**, there is no reason why we should not do so" (p 49). Admitting that money measures objective prices is not the same as saying that money is a measure of value, which is subjective. Subjective value is not measured, but graded. You might choose a red rose over a purple violet, but not be able to scientifically measure the exact amount of the preference.

Later you will learn about intrinsic value ("IV") and buying below IV with enough of a discount to protect against being wrong or miscalculating by having a margin of safety. But many readers would scratch their heads, "How can I determine intrinsic value if all value is subjective?" Valuation is an art despite what you learn from your finance textbooks. There are many different ways to reach a valuation of an asset and no two people will come up with an exact similar estimate of intrinsic value. For now, be aware that investing is not a science; you must be comfortable with uncertainty.

To understand money and basic economics I suggest the following books:

Economics in One Lesson by Henry Hazlitt
http://mises.org/books/economics_in_one_lesson_hazlitt.pdf
Video lectures by chapter: http://archive.mises.org/14406/economics-in-one-lesson-the-video-series/

Mises on Money by Gary North: Link_______
What Has The Government Done to Our Money by Rothbard:
http://mises.org/books/whathasgovernmentdone.pdf

If you want to go further, then explore www.mises.org

CHAPTER 1: WHAT IS VALUE INVESTING?

My father on his deathbed offered me a choice of my inheritance. He said I could choose envelope A with a check for $2 million or envelope B with a formula for developing wealth. Being ambitious, I chose envelope B. I opened it and read just three words, "**Margin of Safety.**"

"Margin of safety?" My dad's last words were, "Buy below intrinsic value with enough discount to have a margin of safety," then he passed on.

But how will I be able to calculate intrinsic value and why would price ever go far below a company's intrinsic value so I could have a margin of safety? How do I go from here to there? I had no CFA, MBA or big bank investment analyst program. Fortunately common sense and a knowledge of business are more important to the investment process than academic formulas.

> *Mr. Buffett says: To invest successfully you need not understand beta, efficient markets, modern portfolio theory ("MPT"), option pricing or*

emerging markets. You may, in fact, be better off knowing nothing of these. That, of course, is not the prevailing view at most business schools, whose finance curriculum tends to be dominated by such subjects. In our view, though, investment students need only two well taught courses--How to Value a Business and How to Think About Market Prices.

I have seen no trend toward value investing in the 35 years I've practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult.

I am a better investor because I am a businessman and a better businessman because I am an investor.

Value investing is simply buying bargains like when you see a sale of quality merchandise. Since growth in profits can increase intrinsic value when investing in franchises, the investor shouldn't be pigeonholed by Wall Street's categories of "growth or "value" investing. A disciplined investor would be careful in how much to pay for future growth.

Mr. Buffett has an eloquent description—to separate growth and value is absurd:

Most analysts feel they must choose between two approaches customarily through to be in opposition; "value' and 'growth'. Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.

We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion the two approaches are joined at the hip; growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.

In addition, we think the very term 'value investing' is redundant. What is investing if it is not the act of seeking value at least sufficient to justify the amount paid" Consciously paying more for a stock than its calculated value—in the hope that it can soon be sold for a still higher price—should be labeled speculation (which is neither illegal, immoral nor—in our view—financially fattening).

Whether appropriate or not, the term 'value investing' is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics—a high ratio of price to book value, a high price-earnings ratio, and a low dividend yield—are in no way inconsistent with a 'value' purchase.

Similarly, business growth, per se, tells us little about value. It is true that growth often has a positive impact on value, sometimes one of spectacular proportions. But such an effect is far from certain. For example, investors have regularly poured money into the domestic airline business to finance profitless (or worse) growth. For these investors, it would have been far better of Orville had failed to get off the ground at Kitty Hawk: the more the industry has grown the worse the disaster for the owners.

Growth benefits investors only when the business in point can invest at ***incremental returns that are enticing****—in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value*[1]*. In the case of a low return business requiring incremental funds, growth hurts the investor….The investment shown by the discounted –flows-of-cash calculation to be the cheapest is the one that the investors should purchase—irrespective of whether the business grows or doesn't, displays volatility or smoothness in its earnings, or carries a high price or low in relation to its current earnings and book value.*[2]

Value investing is partly a state of mind characterized by habitually relating the price of a stock to the value of the underlying business. Basic principles of fundamental analysis are the tools. Ben Graham would consider the term **"value"** investing redundant. *All* intelligent investing is value investing.

DEFINITION OF TERMS

I want to define some key terms in this handbook.

Value Investing: Appraising the intrinsic value of businesses and purchasing fractions of those businesses at significant discounts to those appraisals. Buying bargains.

That is what value investing means when I use the term. What is not to like about value investing? How many people wouldn't wish to be considered value investors? That is why I want to define terms as I understand them.

The definition of **Intrinsic Value** ("IV") is the Present Value of all distributable cash flows whether operating or non-operating over the entire life of the business. Or another way of defining IV is the price at which a buyer and seller—equally knowledgeable and neither one operating under duress—would agree to a transaction for cash. Both of these definitions are easy to articulate, but not so easy to implement or to determine. For example, there are some businesses for which no one can ascertain their value within a tight enough range to be useful to make decisions.

What type of companies are those? A company where the future prospects are so uncertain both good or bad, that no one knows what the long term future or cash flows will be like a bio-tech start-up with new drugs still to be approved. Then again there are businesses that we, I, or you do

[1] We will discuss this in our section on marginal return on invested capital (MROIC).
[2] Buffett, W. (1992).

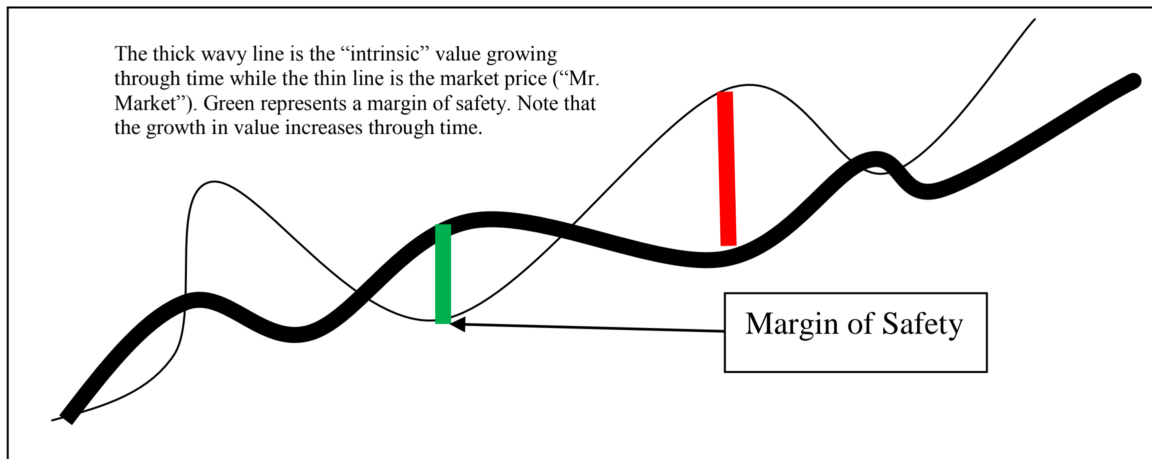
not have the knowledge to project the future cash flows and discount them back--that is a very important element of humility which you should take into this work.

The **Margin of Safety** is, of course, the discount from intrinsic value of the business. Needless to say, in the case of margin of safety, the bigger is better. Margin of safety is typically determined by the price discount but the concept may be embodied in the conservativeness of your assumptions and estimates.

The margin of safety is critical because you may be wrong. Outcomes may be worse than your best guess indicated. The opposite of the cautious, value0oriented, long-term investor is the trader focused on price.

Interrelationships between Intrinsic Value and Margin of Safety

It has to do with the usefulness of the appraisal of intrinsic value. If I conclude that the Intrinsic Value is somewhere between $100 to $300 a share, that is probably not a useful appraisal. If I can't refine it more than that, then I should move on. If the stock is trading at $150 and the range is $100 to $300, then what do I know? I don't know anything of value. If it turns out it *(the company)* is worth $200 to $300 then there may be a big margin of safety there. But if I can't be sure the company won't be worth $100 or not, move on to where the odds seem more attractive--where determining the tighter range is something that I am qualified to determine.



Klarman: We make no heroic assumptions in our analysis, hoping, instead, that by compounding **multiple conservative assumptions**, we will create such a substantial **margin of safety** that a lot can go wrong without impairing our capital much or even at all. We never invest just to invest and don't bet blindly on mean reversion or on historical relationships holding up. Our settings are permanently turned to "risk off."

What is your investing edge? Who is on the other side of your trade?

Combined in this idea of Intrinsic Value and a Margin of Safety is the idea of having an edge. An edge, being the circumstances, that is the opposite of operating on a level playing field. We are all looking for an insight or knowledge edge that allows us to perceive value perhaps where others are incapable of doing that. Find your competitive advantage, your variant perception.

This gets to the question of defining intrinsic value. One thing I want to make sure that you understand is that for some businesses, the intrinsic value is simply not knowable. The array or ranges of possible future cash flows are so wide, so unpredictable, that discounting them back is a fruitless exercise. Additionally, some businesses lend themselves to appraisal by me and not by other people. And for other businesses, some other people are better qualified to assess intrinsic value than I am to make the appraisal. Certain businesses and industries, I feel, I am better able to forecast the cash flows than other people.

There are many, many industries that I am very unqualified to come up with intrinsic value. Or the range of value is too wide to be helpful to me. In those instances I can't come up with an intrinsic value that would be helpful to me.

This is another way of saying, **stick to what you know**—this is *Warren Buffett's* idea to stay within your circle of competence. Therefore avoid being where you don't have the edge. Over the course of this book, we will work on building a circle of competence.

Benjamin Graham (1896-1976) The Father of Value Investing

He also introduced two critical concepts:

Margin of Safety as he described here is a bedrock principle for having protection of capital at the core of your investment process: LINK_______

And the euphonious **Mr. Market**: LINK
Markets are endlessly in flux because people hold subjective values with changing preferences. Mathematical models are misleading.

Mr. Buffett called those two chapters from ***The Intelligent Investor*** the most important ever written on investing. We want to develop a business-like approach to investing.

Next Chapter: **Does Value Investing work?**

Then we will proceed to study Mr. Ben Graham's work