Value investing is about buying a business for a lot less than its intrinsic value

"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."

- Warren Buffett, Columbia University Lecture, 1984

What do we mean by value investing? Put at its simplest, it is the part-art, part-science of learning how to buy a $1 bill for much less than $1. To practice it successfully requires two things only. Firstly, you must have the knowledge to enable you to make a rough estimate about the intrinsic value of an underlying business. Secondly, you must have the intellectual rigour to ensure that you only buy into that business at a price substantially less than you believe it to be worth.

In 'The Theory of Investment Value' published in 1938, John Burr Williams defined the value of a stock, bond or business as being determined by the cash inflows and outflows – discounted at an appropriate interest rate – that can be expected to occur during the remaining life of the asset. The art of investment therefore is to forecast the yield on an asset over its lifespan.

Speculator

Contrast this with the approach of the speculator who is taking a view on the future movement of a share price without ever understanding the underlying drivers of economic value. In other words, forecasting the psychology of the market. Or the momentum investor or chartist who believes that because a share price has gone up already, the situation is somehow more attractive.

In investment, a share represents a fractional interest in a real business and there is no philosophical difference between buying shares in a company and buying the business in its entirety. Focus only on the business.

When I select an investment for the Fund, I look first for a business I can understand; one where I think I understand the product, the nature of its competition and what can go wrong over time. Then I try to figure out whether its economics – meaning its earning power over the next five, ten or fifteen years – is likely to be good and getting better, or poor and getting worse. Next, I try to evaluate its future income and cash streams. And lastly, I try to judge whether I am getting into bed with people I feel comfortable being in business with. Only when all these criteria are met do I try to decide on what seems to be an appropriate entry price for what I have seen up to that point.

Each company you look at will have some unique characteristics, such as its competitive positioning, brand awareness or product set. But the roster of key characteristics is always the same:

- predictability of the business model;
- strength of franchise and growth prospects;
- returns on invested capital; and
- free cash generation.

Establishing where the company is on those four issues will give you 80% of what you will ever need to know.

Successful investment demands that there be a material difference between the price you pay and the value you get. This is your margin of safety and it is only the closing of that Price Value Gap that gives you your profit. There can be no investment profit potential if a company's stock market price is always equal to its value. Fortunately, markets are neither efficient nor rational all the time, despite what the ivory tower academics would have you believe. Market price and business value may be apart for weeks, months or even years. You cannot predict the time it will take for the gap to close, but you know that it will eventually. The only slight fly in the ointment is Keynes' admonition that the market can stay irrational for longer than you can stay solvent! Investment analysis always involves considering both value and price; the trick is to get more in value than you pay in price.

Value and Growth

A distinction is often made between Value Investing and Growth Investing. I'm not sure it is quite so hard and fast. In essence, a growth stock is just another situation where the value has yet to be recognised properly. But it is value investing in its loosest sense because you are putting a value on the future plan rather than what is already there and that is a dangerous place to be. Companies that have gone largely ex-growth are seen as natural shares for trading. What you are trying to do here is buy resilient stuff at a great price. To do this, you must have a margin of safety derived from considering the value of current operations, not the value of the forward plan. This second camp is a much safer place to be.

So, how do you go about assessing the value of a business? There are myriad ways where the science enters into investment.

Discounted Free Cash Flow

Start with Discounted Free Cash Flow. You can build elaborate cash flow models but all suffer from being crucially dependent upon your input variables, like estimated growth rate or working and fixed capital assumptions. Beware the wish being the father of the thought!

One way I get round the subjectivity is to take the most recent free cash flow figure, normalised to eliminate non-recurring events. I run this figure out in perpetuity and discount it back at a demanding hurdle rate of 10%. I choose 10% because: (a) it is an attractive annual total return target for an equity investor; and (b) I am lazy and it has the simplicity that a £3m current annual free cash flow has a perpetuity net present value of £30m. This puts a figure on the present worth of the business.

The value of any business is the present worth plus the additional value generated by the forward plan, which has yet to be delivered by management. If you can buy an interest at or around the present worth, you are getting the forward plan for free. I like that idea. What I like even more is when you can buy it at a discount. Now that's a real margin of safety.