

Defining value

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A couple of weeks ago my colleague, Andre Meyer, questioned in his Global Matters piece whether there was still value in value. But what exactly is “value”? A quick “Google” suggests a common theme – buying stocks that are trading below their true worth or appear underpriced on some form of fundamental basis.

This seems a sensible investment strategy, since value, as measured by MSCI, has narrowly outperformed growth since 1974 (as far back as the indices go). Although, as Andre highlighted, that performance gap has been closing rapidly over the last 15 years.

However, the common theme defining value is rather vague and it is not clear how one should implement a value strategy. There are numerous ways to skin the cat. This is evident when one looks at the performance of various value ETFs in North America. The performance differential between iShares Focused Value ETF, iShares MSCI USA Value Factor ETF, iShares Russell 1000 Value ETF, iShares S&P 500 Value ETF, Fidelity Value Factor ETF and Vanguard Value ETF is stark.

The average return of these “value” ETFs was just over 25% over the last three years¹ but the standard deviation of those returns was high at over 9%. The best performing ETF returned 37% but the worst performing ETF returned just 11% – a huge difference for allegedly providing exposure to the same factor.

Our approach to direct UK equity investing is value oriented, in that it neatly fits the broad definition of buying stocks that appear underpriced on some form of fundamental analysis, but it is materially different from each of the approaches adopted by the ETFs highlighted above.

If one is not buying a stock, they believe it is underpriced then they are instead merely speculating on the direction of the share price i.e. that it will continue in its current direction of travel or violently reverse direction. Some people are better speculators than others. At Momentum, we are investors, not speculators.

Our approach is centred on the concept that capital is scarce and thus flows to where the highest return on that capital can be consistently earned. All companies raise capital from various sources (equity, debt etc) at a cost, invest that capital and generate a return on that capital. Those companies that consistently earn a return on their invested capital over and above the cost of that capital we believe should be valued at more than the total capital that has been invested in that business over time. Conversely, a company that fails to earn a return on their invested capital over above the cost of that capital (and is unlikely to ever do so in the future), should be valued at less than the total capital that has been invested in that business over time.

We trawl through historical annual reports to ascertain the total capital invested in a business and what historical return that business has generated on that invested capital over the years. We also estimate as accurately as possible the blended cost of all that capital. The exercise is not as simple as it might sound, because one must remember that a company's annual report is put together for creditors (be they lenders, customers or suppliers) to assess the credit worthiness of the company and not for equity investors to assess the true worth of the company as a going concern.

A good example is when a business makes an acquisition that subsequently turns sour. If a couple of years after making that acquisition, the company then takes an axe to the carrying value of it on the balance sheet and writes it down by say £100m, then in the latest set of accounts it will almost appear as though that acquisition never took place and that the company never invested £100m plus of capital in making that acquisition. The returns on invested capital that business is then allegedly earning increases (same profit in the numerator divided by a now smaller amount of invested capital in the denominator).



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Once we have established a financial track record for the business, we then typically meet the management team and undertake further exploratory work to better understand the business model and the prospects for the business going forward. This gives us an idea of likely future growth in invested capital and the return likely to be earned on that extra invested capital going forward. We can then derive an estimate of the true worth or intrinsic value of the equity in the business, after deducting other liabilities such as debt.

The best businesses are those that can consistently earn a high return on invested capital and have plenty of opportunities to further invest capital at the same projected high return on capital. We call these businesses “economic compounders”. Our dream investment is in an “economic compounder” but at a market valuation materially below our estimate of its intrinsic value and true worth.

We put a lot of effort into finding such gems, but similar to precious stones, they can be a rare commodity when we are not in times of market stress. We have some of these gems in client portfolios and once we find them, we intend to remain invested in them for a long time. Thankfully, healthy returns can also sometimes be made from investing in “economic compounders” at a market valuation close to our estimate of their intrinsic value, thanks to the compounding nature of those businesses (their intrinsic value increases over time as the companies grow).

Being contrarian also means we can sometimes generate good returns from investing in companies that struggle to generate a return on their invested capital over and above the cost of their capital but trade on a market valuation significantly below the total capital invested in the business. We refer to these as “mean reverters”.

Whilst not the simplest of approaches or the easiest to define, our value approach to UK equity investing certainly keeps us busy and is able to generate lots of opportunities for us to grow the capital our clients entrust with us.

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