Getting Started in

VALUE INVESTING

Charles S. Mizrahi

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In memory of my grandfather
Louis A. Baskin
who added value to everything he touched

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In addition to allowing me to marry their only daughter (for which they have my eternal gratitude), my in-laws, Richard and Sallie Mishaan, have been a constant source of encouragement and inspiration.

While growing up, my parents, Billy and Janice Mizrahi, provided me with an environment that allowed me to develop my love of learning and reading. They gave my brothers and me total freedom to find our own way in life while gently guiding us from the wings. I hope I can have the same faith in my children that they had in us.

For over a quarter century, my brother Gary Mizrahi has been my partner, confidant, most outspoken critic, and friend. The great businessman William Wrigley once said, "When two men in a business always agree, one of them is unnecessary." Our relationship is one in which we bring our own viewpoints and strengths to the table, and it has made working together both a challenging and a rewarding journey.

I have been blessed with the greatest children a father could ask for: Janice, Billy, Ritchie, Jeffrey, and Steven. I pray that you always keep in mind "what the Lord requires of you: only to do justice, and to love goodness and to walk modestly with your God, then will your name achieve wisdom" (Micah 6:8).

I owe the deepest gratitude of all to my wife Ellen, a true woman of valor. "Many women have done well, but you surpass them all" (Proverbs 31:29).

I couldn't agree more with Sir Isaac Newton, who said, "If I have been able to see further, it was only because I stood on the shoulders of giants." I have been very fortunate to be able to learn so much from so many. It is now my turn to pass it on.

Getting Started in VALUE INVESTING

Introduction

Value Really Means Something

I have seen no trend toward value investing in the 35 years I have practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult.[1]

—Warren Buffett

"I just don't have a head for investing, don't waste your time," my mother told me. It was a cool fall afternoon and already starting to get dark when Mom and I were sharing a pot of herbal tea. My mother always avoided the subject like the plague because to her investing and everything related to it was one big black hole. It was a place where information was likely to be siphoned away and never seen again. I couldn't blame her. Since I was a teenager, she had always seen me with either a book in my hand or leafing through a company's latest annual report—scribbling down notes and calculating numbers. Dad had always taken care of the family finances and still did. But I felt strongly that Mom should have some idea of how to manage money too.

After my further pleading, she told me that I could have two minutes; if she couldn't grasp it by then, it would be the last she wanted to hear on the subject. Sitting at the kitchen table, I knew this was the only chance I would get and I couldn't blow it. "Mom, how much do you pay for a half gallon of milk?"

Without hesitating for a nanosecond she replied, "$1.49." If she went to the supermarket and milk was selling at $4.99, would she buy it? "Are you crazy, not a chance," was her answer. How about if the same milk was selling at another supermarket for $0.79, would she buy it? "In a heartbeat, I would probably buy three," she beamed.

"Mom," I said, "you just described the essence of value investing: Make a purchase only when you get more value for your money, or keep walking. The rest is commentary."

The Miracle of Turning Clear Water into Mud

Wall Street has a way of making something simple seem extremely complex. Like the Wizard of Oz, Wall Street has done a terrific job complicating, confusing, and intimidating, so that people with average intelligence feel rather stupid. Many times Wall Street does one thing and tells investors to do the exact opposite especially when it comes to investing their nest eggs in mutual funds. A mutual fund's marketing department preaches buying shares and holding them for decades, yet the portfolio managers of those very same funds hold them in the portfolio only an average of nine months.

Getting Started in Value Investing cuts through all the obstacles that have been placed in your path for making sound investment decisions. After reading this book, you will have a firm grasp on how to make an informed decision on what types of stocks to buy, and, more importantly, what to avoid. You will also have a solid foundation with an approach that has worked on Wall Street for the past 70 years. How well you do will depend on how successful you are at keeping your emotions in check and avoiding the latest fads on Wall Street.

The Stock Market at the Turn of the Twentieth Century

One hundred years ago, there was no effective regulation in the stock market. So insider trading and even outright manipulation were commonplace and the average person was at a clear disadvantage. Until 1910, the New York Stock Exchange (NYSE) reserved a special "unlisted department" for companies that did not even disclose *any* financial information. By 1926, nine out of 10 NYSE firms submitted some form of financial audit, but this was not required until the FDR-era reforms of 1933 and 1934. Many so-called preferred list securities were sold privately even before shares were offered (at higher prices, of course) to the general public. During the abuses of the 1920s, no fewer than 100 NYSE-listed stocks had prices fixed, and nothing seemed to effectively remedy these problems.[2]

With scant accurate financial information, investors bought and sold stocks based on Ouija boards and superstition. J.P. Morgan, the most powerful banker and financier in the early 1900s, was known to have said that "millionaires don't use astrology, billionaires do."

During this time, investors were groping for anything that could help them predict the future direction of stock prices. At the turn of the twentieth century W.D. Gann, known to his followers as the founding father of financial astrology, believed that specific geometric patterns and angles had unique characteristics and that these could be used to predict price movements. In 1934 the Dow Theory, which was based on trends in price for the Dow Jones Industrial and Transportation Average, was gaining a wide following. In 1938, Ralph Nelson Elliott developed the Elliott Wave Theory, which said that the stock market trades in repetitive cycles, which could be divided into patterns he termed "waves." Trend lines, price patterns, astrology, and waves were just a few of the ways investors used to predict price movements; I kid you not. A different way of looking at the market was still some years away.

> *"Thousands of experts study overbought indicators, oversold indicators, head-and-shoulder patterns, put-call ratios, the Fed's policy on money supply, foreign investment, the movement of the constellations through the heavens, and the moss on oak trees, and they can't predict markets with any useful consistency, any more than the gizzard squeezers could tell the Roman emperors when the Huns would attack."*[3]
>
> *—Peter Lynch*

Dawn of a New Way of Thinking

At the age of twenty, Benjamin Graham graduated from Columbia University in 1914 and was asked to join the faculty of three departments—English, philosophy, and mathematics. Instead, Graham went to make his fortune on Wall Street starting as an analyst, and then managing an investment partnership. In 1934, Benjamin Graham and coauthor David Dodd wrote the book *Security Analysis* in which they laid out the intellectual framework for what was later called value investing; this book was geared to the professional investor. This work was like a ray of sunshine peeking through the clouds of confusion. In 1949 Graham followed up with *The Intelligent Investor*, a version of his earlier book but this time aimed to the individual investor.

Graham's approach to analyzing a stock could be boiled down to three major points:

1. Think like a business owner. When making an investment in a stock, keep in mind you are buying a part of a business.
2. The stock market is there to serve you, not instruct you. Most of the time, the stock market prices businesses correctly. However, there are times when the stock market greatly overvalues or undervalues businesses.
3. Make a purchase only when there is a gap between the stock price and the underlying value of the business. The wider the gap the more "margin of safety" you have.

Throughout this book, you will meet some of the investors who learned at the feet of Graham as a teacher and/or employer. Each one attributes their success to the philosophy laid out by Graham more than 70 years ago and has the track record and net worth to prove it works.

Old Habits Die Hard

Many studies and papers have been written over the past several decades on how value investing works. In later chapters, I summarize a few landmark studies that make the point. None of this, however, has stopped academics from trying to prove that the market is efficient and there is no way that an investor can beat the market. For example in the 1970s the Efficient Market Theory (EMT) became quite popular in the halls of academia. In a nutshell, EMT says that all market participants receive and act on all information as soon as it sees the light of day. Those who follow this theory believe that there is perfect information in the stock market. As soon as information becomes available about a stock, everyone has it at the same time, and the price of the stock should reflect the knowledge and expectations of all investors.

In other words, don't waste your time analyzing companies; it will do you no good. How do proponents of EMT invest their own money? Since making stock selections in order to outperform the stock market is futile, they buy a stock index fund and are happy to match the stock market's return. The main flaw in this theory is that it neglects to take into account the number one reason the stock market becomes inefficient at valuing companies: human emotion. When it comes to money, most people hate losing. During periods of panic, investors won't pick up $1 bills selling for 50 cents with a 10-foot pole. Efficient markets become very inefficient when fear grips Wall Street. Business schools continue to teach EMT and as a value investor, you should be glad. Warren Buffett took a positive view regarding EMT and wrote:

> In any sort of a contest—financial, mental, or physical—it's an enormous advantage to have opponents who have been taught that it's useless to even try. From a selfish point of view, Grahamites should probably endow chairs to ensure the perpetual teaching of EMT.[4]

What You Find in This Book

I have written this book for the average person who wants to develop an understanding of what value investing is all about. Once you have finished this book, you will be among a select group of investors able to view the stock market and all the noise that surrounds it with more clarity and peace of mind.

Chapter 1 explores the most common misconceptions investors have about value investing and explains why they don't work in the real world. In Chapter 2, I take you through the basics and provide you with the compelling logic of value investing. Here you will see why this is the only approach that has withstood the test of time.

Following these basics, Chapter 3 gives you a framework for investing in stocks, and even shows you why putting all of your eggs in *one* basket simply makes sense and improves your overall return. Chapter 4 examines another important concept, which is finding businesses that truly are the champs. In Chapter 5, I explain the importance of picking not only great businesses but great managers as well, which is another way of adding value. Chapter 6 explains the importance of competition and why certain companies invariably have a strong competitive advantage.

Chapters 7 and 8 give you sound nontechnical explanations of a company's financial statements, how to read them, and what you need to make value-based interpretations. In Chapter 9, I tie up the whole concept by explaining how *price* and *value* differ, and how to determine exactly what you should pay for a stock. Chapter 10 is devoted to reminding you about some of the mistakes people make in the way they invest, and why, as a value investor, you actually simplify your decision-making process by sticking to a short list of tried-and-true ideas. I provide you with some final thoughts in Chapter 11.

Words to Live By

Warren Buffett has often said that intelligence is no guarantee for success when it comes to investing. He has observed that anything above a 125 IQ is wasted.

You certainly don't have to be the smartest kid in the class to apply a value approach to investing. And if you were never good at math or do not have a head for numbers, so what? That will probably be an advantage since you won't be bogged down in detailed analysis. You will be better able to focus on what makes your portfolio tick: the business (stock) you are buying. Instead of spending hours looking at the cash flow statement, you will be asking yourself relevant questions like: What edge does this business have? Is management candid? In other words, the qualitative stuff that is not so readily found in the numbers.

Your present occupation should not be a barrier, either. Great value investors come from all walks of life: a lawyer (Charlie Munger), IBM salesman (Rick Guerin), chemistry major (Tom Knapp), advertising executive (Stan Perlmeter), high school graduate (Walter Schloss). Most people get the concept of value investing in five minutes or less, and that's the point: It isn't complex or overly technical. You can do it.

> *"It is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesn't take at all."*[5]
>
> *—Warren Buffett*

So turn the page and let's begin.

Chapter 1

The 5 Misconceptions of Value Investing

We've long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.[1]

—Warren Buffett

Whenever I go to a dinner party or social gathering, a friend or acquaintance usually asks my opinion on the economic news flash of the day. For example, if the media are talking about the DJIA making an all-time high or an unemployment report coming in better than expected, people who know that I manage a limited partnership and write an investment newsletter want to hear my take on current economic events. I usually respond the same way each time I am asked: "I really don't have a clue how it will affect the stock market or the economy." I'm not trying to brush them off, but I really don't know. In fact, I don't even take those factors into account when making a purchase.

DJIA

An index of 30 stocks traded on the public exchanges. It is the most widely known index and is used as a measure of the health and direction of the overall stock market.