The Valuable World of Value Investing

It's the go-to strategy for Warren Buffett, but it's definitely not a get-rich-quick formula.

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"All investors including Buffett make mistakes; it is how they manage these mistakes that sets certain investors apart," one expert says. (ISTOCKPHOTO)

If you look up "The Intelligent Investor" by Benjamin Graham on Amazon.com, you'll find that 69 percent of the 1,100 or so reviewers give it five stars, while 13 percent dismiss it with one, two or three stars. How many of those unimpressed reviewers would rather follow a hothead like Jim Cramer the website doesn't say.

But perhaps those naysayers missed the one review that trumps them all: the one from billionaire Warren Buffett. He calls "The Intelligent Investor" "the best book about investing ever written." That dovetails nicely with the squib of a far lesser known reviewer, one "Paige Turner," who dubs it "Shakespeare for the Investing Crowd."

Turning the page from Graham's 1949 book to now, value investing boasts Buffett as its most famous proponent. And while he has countless disciples, the Oracle of Omaha was in turn a Graham groupie himself; after reading "Investor," he went to study under Graham at the Columbia Business School.

Granted, value investing, like so many a term culled from the world of finance, has a faint ring of jargon to it for some newbie investors. Poke behind the name, though, and value investing has principles that are fairly easy to understand – if hard to stick by in a go-go age of instant gratification 2.0 (otherwise known as instant instant gratification).

"In its simplest form, the valuation of the stock of a given company can be calculated by viewing its current price versus its book value," says Kevin Mahn, chief investment officer at Hennion & Walsh in Parsippany, New Jersey. "If the price is below its book value, one can infer that it's undervalued – and if the price is above its book value, one can infer that it's overvalued."

And to make the most of this, value investors such as Buffett subscribe to a strategy known as "buy and hold," which is exactly what is sounds like: Buy a stock and hold onto it, often for years or decades.

There's also the strategy of following the money. "I like to find undervalued companies where corporate executives are buying heavily with their own money," says Mike Chadwick of Chadwick Investment Advisors in Unionville, Connecticut. "That's normally a very powerful recipe for long-term results."

It also helps to know some of the measurable metrics that will help determine when a company is a good value. "Price-to-earnings and price-to-book ratios are great ways to tell if a company is indeed undervalued or not," Chadwick says. "There are dozens and used together it's the best recipe."

But like any other way of approaching the market, value investing has its limits – especially when it comes to sectors that might as well have the word "relic" etched all over them.

"The classic value trap arises where a stock looks inexpensive on the surface but the business is in a structural, rather than cyclical decline, and further downside is in store," says Mike Beall, executive vice president at Davenport Asset Management in Richmond, Virginia. "History is littered with value traps, such as Eastman Kodak (twitter: KODK) in photography film, Kmart and Sears (SHLD) as failed retail concepts, newspapers, etc."

"All investors including Buffett make mistakes; it is how they manage these mistakes that sets certain investors apart," says Allen C. Benello, co-author of "Concentrated Investing: Strategies of the World's Greatest Concentrated Value Investors," and founder/general partner of White River Investment Partners in San Francisco.

"Value investing is a discipline that helps an investor make smaller and less frequent mistakes, and having a slightly better hit rate and a slightly lower failure rate makes a huge difference in long-term returns," Benello says.

The detective work in spotting the winners often starts with a simple concept known as asset valuation. Bello's co-author, Michael van Biema of van Biema Value Partners in New York, cites this example:

"Let's say one is buying shares in a jewelry company and the company makes only pure gold jewelry," van Biema says. "If one can buy all the shares of this jewelry company at a price that's a significant discount to the value of the gold alone, one has a significant margin of safety." And hence, a value investment.

"Academic studies have consistently shown that a portfolio of value stocks has outperformed the market historically," says Ken Little, managing director of investments at Brandes Investment Partners. "That said, there are extended periods when value investing goes temporarily out of favor and underperforms. In many equity markets around the world, we have been experiencing just such a period for the past seven-plus years."

"Value investing can often go hand-in-hand with contrarian investing," Beall says. "The key is differentiating between cheap stocks likely to bounce back versus the value traps. … Remember that sometimes it is OK to pay up for a great company with a great outlook."

So when does it make sense to go the value route? Beall says: "Ultimately, our litmus test is reflected in one question: Would an informed business person – and I like to think that includes us – buy the whole business at the current price and hold it for the long term?"

In other words, if you're breaking the way of value investing, it's fundamental to know your investing values.