



Two Natural Advantages of Value Investing

- Understanding benefits of “growth” styled investing is easy: a company increases sales, earnings rise, and the stock price grows with it. The faster, the better. Understanding the benefits of value investing tends to be less straight forward, but every bit as pragmatic.
- The two natural advantages relate to 1) buying something that is *too* out of favor, and 2) the accounting dynamics of earnings received per dollar invested.

Natural Advantage Number 1: *Too Out-of-Favor*

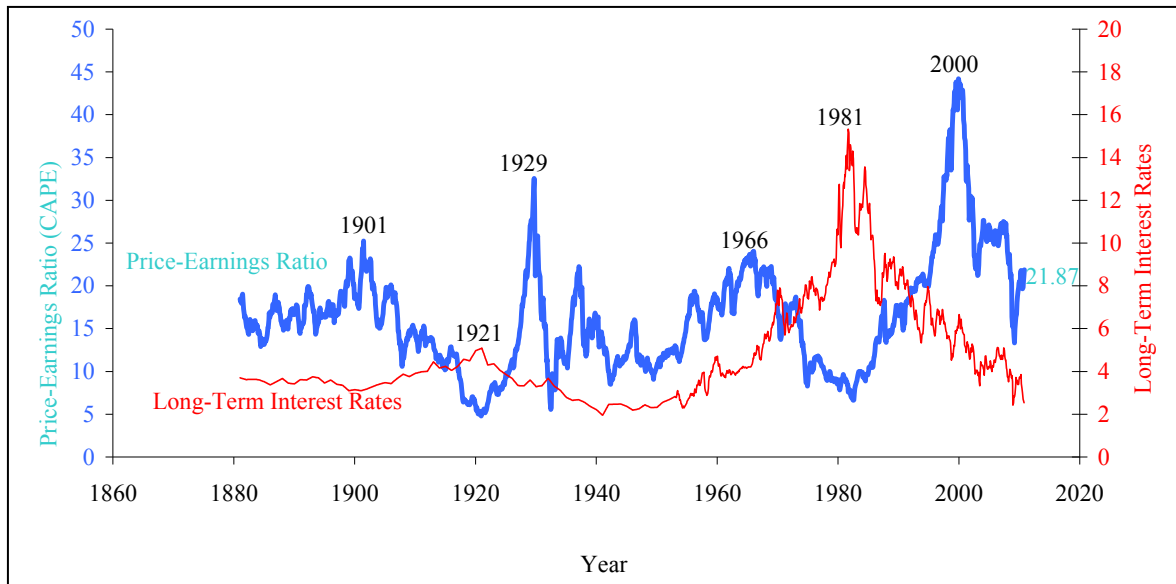
Most people envision value investing as buying something that is cheap with the prospect that it becomes less cheap. I agree. Generally, an under-priced / over-sold company with a good stable business swings back into vogue (though unlike a pendulum, you can't set your clock to this... otherwise we'd all be value investors).

One way of studying this concept is to look at the broad stock market over longer periods of time. Professor Robert Shiller of Yale University has done a great favor to value investors when he published a good deal of research and data on the US Stock market from 1871 to present.

Interestingly, Shiller focuses on bubbles, which in some ways is the opposite of value-investing. He makes the point that market participants (focusing on housing and stock markets) tend to become over ebullient, thus irrational. This eventually leads to pricing corrections.

In studying the stock market, Shiller looks at the S&P 500. He removes the cyclical nature of corporate earnings by averaging 10-years of earnings and adjusting for inflation. The result yields a cyclically-adjusted earnings figure, which he calculates for all months between 1881 and today (over 1500 months).

Comparing the market's price to these earnings provides a Price-to-Earnings (P/E) ratio, which he calls the Cyclically-Adjusted P/E ratio (CAPE). Below is a chart of the CAPE from 1881 through today.



Source: Robert Shiller, Yale University.

As can be observed, Shiller’s P/E ratio peaks a few prominent periods prior to severe corrections.

To add to this study, we can calculate 10-year returns for the stock market following each P/E ratio (1400+ periods). Below is a chart demonstrating 10-year inflation-adjusted subsequent returns grouped by each Shiller P/E ratio.



Source: Yale University, Laureola Asset Management.

This indeed seems to demonstrate that “too out-of-favor” tends to become less so overtime.



Another interesting observation is that while the stock market P/E reached a historic peak in early 2000 and subsequently corrected severely through 2002, other less-over-valued portions of the market did not correct.

Specifically during this bubble burst, the S&P 500 returned -34% (2000 through 2002). On the other hand, Russell's Mid-Cap Value index returned +11% and Russell's Small-Cap Value Index (Russell 2000 Value) returned +27% - over the same period. The point being that the market's valuation and performance does not necessarily dictate other market segments.

Consequently, as today's market valuation seems to be approaching less attractive levels (Shiller P/E of 22), there are a variety of sectors and stocks that remain attractively valued.

Other studies that lend credit to the *Too Under-Valued* theme look at individual stocks. Eugene Fama and Kenneth French's famous 1992 study of a broad universe of individual stocks over a multi-decade period, for example, showed that smaller stocks with more attractive valuations (price-to-book ratios in this case) tend to significantly out-perform their larger less-attractively valued peers.

In the end, the natural advantage of *Too Under Valued* is a longer-term theme and requires patience at a minimum. Essentially, investors benefit from good "positioning," which tends to pay off.

Natural Advantage Number 2: The Dynamics of Earnings Received per Dollar Invested

Along with the idea of patience, one of the main arguments against investing in an attractively valued stock is that its price, P/E ratio, etc. *stay* too low. Fair enough. However, even in consideration of this, the second natural advantage of value investing demonstrates that attractive returns are more than possible even in this situation.

The second natural advantage reflects more on what a company does with its earnings and how that benefits shareholders. The main premise is that earnings come back to the shareholder in one way or another and valuation makes a difference. If someone invests \$100 in a business and his stake represents \$10 in earnings... that is better than \$5 in earnings. This is exactly the difference between a P/E of 10 versus 20.

First, let's consider earnings from a company's point of view. When a company earns money, management needs to decide what to do with those earnings. There are three primary ways a company can utilize earnings. A company can: 1) keep its earnings in hopes of growing future earnings (via internal projects, hiring, expansion, acquisition, etc.), 2) pay out earnings in the form of a shareholder dividend, or 3) buy back its own shares on the open market.

Companies tend to do a combination of these in any given period, but all three activities tend to benefit shareholders despite a stock's valuation. However, while the first option does not give value investors an advantage (or disadvantage), the second two do. In aggregate, larger benefits



are passed on to value investors. To demonstrate, let's look at three scenarios reflecting each of the ways a company can use its earnings. We will be making some assumptions, but the general effect is demonstrated.

Option 1: A company keeps (retains) its earnings

When a company keeps its earnings, these dollars serve as additional capital. This additional capital grows at a rate of a return, known as return on invested capital (ROIC) – say 10%. In this case a company can grow total future earnings by about 10% annually over time by retaining all of its earnings (assuming ROIC remains at 10%).

If the same company only keeps 50% of its earnings, it would grow future earnings by about 5%. As this approach impacts total earnings growth, it is neutral to valuation. On a side note, ROIC levels also seem to be neutral among value versus growth companies (currently around 7% each in my database).

Option 2: A company uses earnings to pay dividends

When an investor buys a company with a P/E of 10, this is the same as \$1 earnings per \$10 invested, which also is referred to as an earnings yield. This earnings yield would be 10% (1 divided by 10). Under this situation, if the company pays out 100% of its earnings, the dividend yield would therefore be 10%.

Contrast this to a company with a P/E of 20. If this company pays out 100% of its earnings, the stock would have a dividend yield of only 5%.

Consequently, the first company provides a 5% income advantage when calculating the total return on the investment. This shows a distinct cash-flow advantage by focusing on value in consideration of “earnings per dollar invested.”

Option 3: A company uses earnings to buy back its shares in the stock market

Finally, consider the value advantage of share buy backs. For a company with a P/E of 10 (earnings yield of 10%), it's essentially earning 10% of its market capitalization. If this company spends 100% of its earnings to buy back its shares, it could theoretically reduce shares outstanding by 10%. After this happens, the same level of earnings in future periods is spread over a smaller number of shares outstanding. Specifically in this example, a 10% reduction in shares outstanding increases future earnings per share (for the same level of earnings) by 11.1%.

Typically, as earnings per share increase over time, prices increase. For this company, the price would have to rise 11.1% just to maintain a P/E ratio of 10 (otherwise the P/E ratio would drop with no change in share price and a same level of total company earnings).

Whereas a company with a P/E of 20 can only buy back 5% of its shares outstanding, which would increase earnings per share (for the same level of earnings) by a lesser amount (+5.3%). Thus, an increase in price of 5.3% would maintain a P/E ratio of 20.

Essentially, earnings-per-share increases are greater (as a result of buybacks) for lower P/E stocks versus higher P/E stocks. So in order to maintain P/E ratios, share price increases are greater for lower P/E stocks.



Buy Back Example 1: Low P/E Stock

	Period 1		Period 2	Change
Market Capitalization	1,000		1,000	0.0%
Net Income	100		100	0.0%
Shares Outstanding	100	=== income can buy up to 10% shares===>	90	-10.0%
P/E Ratio	10		10	0.0%
Earnings per Share	\$1.00		\$1.11	11.1%
Price	\$10.00	=== price corrects to maintain P/E ratio===>	\$11.11	11.1%

Buy Back Example 2: Higher P/E Stock

	Period 1		Period 2	Change
Market Capitalization	2,000		2,000	0.0%
Net Income	100		100	0.0%
Shares Outstanding	100	=== income can buy up to 5% of shares===>	95	-5.0%
P/E Ratio	20		20	0.0%
Earnings per Share	\$1.00		\$1.05	5.3%
Price	\$20.00	=== price corrects to maintain P/E ratio===>	\$21.05	5.3%

Considering what companies do with their earnings, the premise of the second natural advantage to value investing (Earnings Received per Dollar Invested) is that earnings tend to eventually find their way back to shareholders through increasing total net income, dividends, and share buy-backs. The more earnings per dollar invested – the better.

Summary Example: Natural Advantage Number 2 (The Dynamics of Earnings Received per Dollar Invested)

	P/E 10	P/E 20
Retain All Earnings (ROIC 10%)	Net Income +10%	Net Income +10%
Dividends (100% Earnings Payout)	Dividend Yield 10%	Dividend Yield 5%
Share Buy Backs	EPS +11.1%	EPS +5.3%

Conclusion

Value investing is one of many successful investment approaches. Understanding and acting on these natural advantages offers a responsible way to outperform the market over time. These natural advantages stem from the price appreciation tendency of under-valued investments and the dynamics of earning per dollar invested. Without question, a host of additional research needs to go into any investment decision, but value as a top priority is not a bad thing.





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