The mystery of value investing: How is value unlocked?

A good value investor never lets her capital leave home without an identified catalyst

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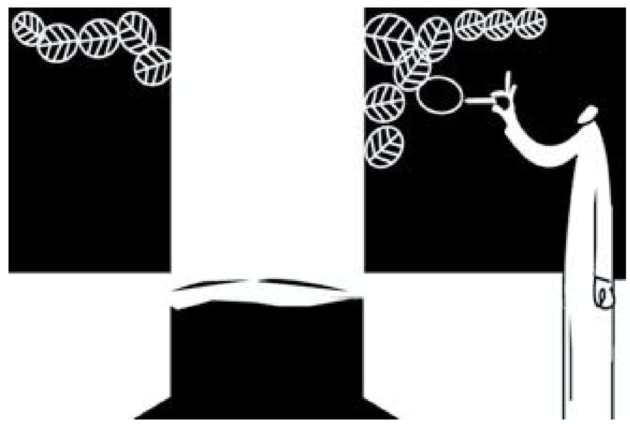

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Chairman J. William Fulbright: What causes a cheap stock to find its value?

Benjamin Graham: That is one of the mysteries of our business, and it is a mystery to me as well as to everybody else. [But] we know from experience that eventually the market catches up with value.

Testimony to the Congressional committee on Banking and Commerce, Chairman: Senator Fulbright (1955).

How a “value” investment finds its value is one of the enduring mysteries of this discipline. While value investors themselves struggle with this concept, non-value investors get frustrated and many don’t adopt this technique because they just cannot see how it can be done. Many reject it since to them, ex-ante, a value investment is likely to remain undervalued for an indefinite period.

What gives a value investor confidence that value will be unlocked? There are different kinds of value stocks, and the precise answer is different. But the answer lies in one word: catalysts.

The Oxford English Dictionary defines it as a person or thing that precipitates an event. Let us take the case of a stock that is bought below its net asset value. Say, the principal assets are cash, stocks, bonds or other liquid assets on the books. In this case, announcements of a special dividend, stock buyback, acquisition or expansion plans, which will increase operating assets that have high profitability, will act as catalysts. Sometimes a mere management change will be enough to catalyse the value unlocking process.

In some companies, which have a division that has significantly low profitability and which is hampering the growth of the whole company, an announcement of either selling the division or getting it listed independently will also act as a catalyst. Another potential catalyst in the case of a highly indebted company is the announcement of equity infusion by a strategic investor with the aim of reducing the debt. For cyclical companies, as sales begin to pick up, profitability starts to increase, either from losses towards profits or from lower to higher profits. The first quarterly earnings report that turns positive is quite often the catalyst.

One can get into these situations, before the event, knowing the potential catalyst that can unlock the value. But the timing is still not known. A typical horizon can be of two-three years, but can sometimes be as high as five years. For these situations, one needs to know that the company is available at a nearly 50% discount to its intrinsic or net asset value. This means that after the catalyst unlocks the value, the stock will eventually double. Assuming that the holding period is one year, this will mean a 100% compounded annual growth rate (CAGR); for two years, it will mean 42% CAGR, 26% for three years, 19% for four years, and 15% for five years. This means that as long as one buys a stock at a significant discount to its intrinsic value, even a fairly long holding period can give decent returns.

Now, we move to the typical case of a value stock that is profitable but without growth in earnings. The fact that it is profitable is more important than the specific profitability. In these cases, the market is valuing it below its intrinsic value since the near-term outlook for a few quarters might not be growth-oriented. Quarter-on-quarter, earnings are accumulating and adding to the net worth of the company. Hence, the net worth is consistently increasing. This is making it cheaper on a price-to-book basis even though the price might not increase. At some point, someone is going to notice, and the price will at least start growing at the pace of growth in book value due to earnings’ accumulation. If the company is paying a dividend, it is likely to be increased along with the growth in book value. The dividend yield cannot become very high since dividend seeking investors will start piling in at higher yields. This provides a floor for the price of the stock where dividend yield becomes comparable to fixed income returns adjusted for taxes.

In these cases, at some point, the business picks up since whatever was causing stagnation in the near-term earnings has played out and sales growth has started.

The case of growing value stocks that might be selling below their intrinsic value due to slower-than-expected growth rates in the near-term is similar. In these cases of profitable value stocks, whether growing or not, one must not only know the nature of the catalyst beforehand but also estimate its timing with more accuracy. Doing so helps in monitoring the potential catalyst during the holding period—how far it is on the horizon.

In all these cases, what gives comfort and holding power to the value investor is that she knows what she is waiting for and how long the wait might be. Also, what is expected from each quarterly and annual statement is clear.

There are more value situations and just as many catalysts—mergers and acquisitions, delistings, spin-offs, reorganizations, refinancing or recapitalization, and others. Where there aren't visible catalysts, activist investors sometimes get in and do the needful. Keep in mind to buy a diversified portfolio of value stocks to maximize probability of catalysts. A good value investor never lets her capital leave home without an identified catalyst.

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