Is Value still Relevant in 2018?

Value investing is a methodology predicated on the idea that it is a much better idea to pay less for something than it is worth. Conversely, it is speculative, at best, to pay more for something than it is worth. This premise should be inherently obvious to everyone. But life is complicated – consultants and index providers, amongst others, have attempted to define value and growth through contrived and spurious methodologies. Thoughtful investors will not allow themselves to be confined by these methodologies, preferring more useful valuation techniques. "Value" managers who are in the process of capitulating under the duress of periodic underperformance, will also not allow themselves to be confined by these methodologies, preferring more convenient valuation techniques. As Charlie Munger has stated, "anyone who thinks it's easy is stupid." Most of those who migrated to more "modern" valuation techniques in the late 1990s eventually got walloped. Today, once again, many managers and academics are articulating some interesting and thought-provoking reasons for not anchoring to valuations methodologies of past eras. We have great sympathy for much of what is being said having recently penned the commentary entitled, "Master and Servant," which argues the very point that servitude to dogma can be hazardous. So the question before the house is: should managers be changing (updating) the models that they use and the accounting upon which those models are driven?

We, of course, don't have the definitive answer, but we do have opinions. For what it's worth, here are some of them. First, regardless of the era, we have always argued that value wasn't a philosophy, but, rather, a prerequisite. Value is a complicated concept that can't be "put in a box." Metrics are a tool to ascertain the value of a company, not a mechanism to assign value to a company. Kopernik has always prescribed the use of multiple metrics, thoughtful metrics, and industry-tailored metrics. Some proclaim that managers shouldn't allow themselves to be constrained by price-to-book. This is true, but not because of the era we live in. Book value is merely one metric, and possesses many attributes and challenges. It has always been more useful for appraising asset-heavy companies than for appraising asset-light companies, for example. There are some good arguments against over-reliance upon book value such as its failure to capture goodwill and brand value that has accrued over time. Conversely, it does capture goodwill that isn't really economic goodwill, but rather is evidence of overpayment for past acquisitions. By expensing, rather than capitalizing, labors that can lead to 'permanent' competitive advantage, accounting records can understate true economic value. Furthermore, book value has less meaning in an era where value increasingly comes from intangibles rather than from tangible assets. It is too restrictive in an era where margins are 'permanently' higher due to 'permanently' low interest-rates and higher leverage, resulting from enlightened central bank policy, the breakdown of antitrust enforcement, 'permanently' lower tax rates, 'permanently' lower wages and need for labor. And maybe of more importance than anything else, stock buybacks, and other expensive purchases, have distorted book value numbers beyond recognition. Last year set a record for stock buybacks and this year is leaving that record in the dust. It is estimated to exceed $1 trillion (yes, trillion with a T).

We concede that in many cases book value is not relevant. Yet many of the detractive arguments ring hollow. For starters, technological change has always made many companies worth much more than their book value, while damaging other companies and causing them to be worth far less than book value. This is nothing new. Social media, gene editing, search engines, and smart phones have been complete game changers. Might that have also been the case for air conditioners, telephones, telegraph, rail road, canals, vacuum tubes, semiconductors, automobiles, airplanes, the printing press, and so on through the millennia? Book value proved a useful measure through many eras – might they still mean something?

Moving on – if a company buys their own stock back at a premium to book value, but at a discount to its economic value, we can all agree that book value becomes misleading; book value per share goes down while economic value per share is actually increasing. However, if the buyback occurs at a premium to book value and at an even bigger premium to economic value, then the drop in book value per share is accurately reflecting a loss in economic value. Economic value is a somewhat subjective concept but one should be cognizant of two highly relevant points: recent buybacks have been occurring at record prices and valuations; history shows that record levels of buybacks always occur near market peaks. What is the chance that managements are actually adding value through these buy-backs? Investors can disregard the resultant lower book value at their own peril.

Regarding the concept of "long-term, value-creating, intangibles," giving examples of stocks that turned out to be worth a lot more than book value can be dangerous and is what is known as 'cherry-picking.' Over the decades, many companies have hired engineers, scientists, marketing whizzes, and others who have endeavored to create intangible value in the form of superior ideas, products and services. Most have failed to do so. Some achieved their fifteen minutes of fame. And a select few have created long-term value. Because success is a longshot, all of the major accounting authorities have correctly mandated the costs involved with R&D, advertising, marketing, and similar efforts be expensed as they've occurred, rather than capitalized. To cherry-pick the ones which succeeded, and use them as proof that efforts to build brands and create technology should not be expensed seems disingenuous, even dangerous. Many of today's clear winners will be tomorrow's Schlitz beer, Sony Walkman, Blackberry phones, etc. We just don't know which ones, yet. Caveat emptor.

People should also beware of arguments that don't factor in price. If a company should be purchased because they have the best technology and/or the best ecosystem, market share, management, brand, country of domicile, distribution network, etc., does that argument apply to any price? $20 per share? $40? $400? $4000? $40,000? We view price as the most important variable in any equation.

If price-to-book value doesn't carry the same gravitas it once did, **what about price to: earnings (normalized); sales; replacement value; liquidation value; GDP; cash flow? When the market is at, or near, the most expensive level ever when appraised on any of these metrics – can one really afford to rationalize it away?** Does the "new era" really negate the laws of mathematics? Has human nature evolved beyond emotion? Does greed no longer lead to excess? Does excess no longer lead to lower returns in the future? Can Apple, Google, Facebook, Netflix, Amazon, Baidu, Tencent, and Alibaba compete against each other and all win? With the size of government claims now the highest percentage of GDP ever, and debt claims against GDP the highest ever, and equities now priced near the largest percentage of GDP ever, can the new economy really support that? Keep in mind, all of these claims are senior to the claims of equity-holders.

Furthermore, can value really be found amongst a feeding frenzy for the super-popular, high-profile stocks? When everyone owns "quality franchises," can they really be bargains? When billions of dollars are flowing into the FAANG stocks every hour, is it even conceivable that they are underpriced? **Doesn't value investing by its very nature require a contrarian bent?**

On the other side of the coin, the fact that intangible value may occasionally be overlooked does not mean that tangible assets don't still have value. The current investor stampede into intangibles has left tangible assets neglected and underpriced. Many dominant companies can be purchased at significant discounts to tangible book value. And while tangible assets may be way less sexy than their intangible brethren, they are safer by a wide margin. As previously mentioned, today's must have technology is tomorrow's memorabilia. Meanwhile, mobile service infrastructure, electricity distribution systems, reserves containing metals, railroad systems, farmland, and many other similar assets are highly unlikely to become obsolete in our lifetimes. They will continue to be inherently valuable over time. Regardless of how the anointed stocks perform, buying these valuable tangible asset at a sliver of their intrinsic value seems destined to be a highly rewarding undertaking.

In early 2000, we said to clients, "it may sound like sour grapes, but if a manager had a good year in 1999, you should beware." In the current, equally narrow and bifurcated market, we will reiterate that sentiment – it may be sour grapes, and we may be wrong, but we would suggest extreme caution regarding pronouncements of the death of value, and be very wary of any manager which is excelling in this current exuberant period. Our recent commentaries, *Runaway Train* and the *Weight of the Wait* provide more in depth narrative on the pain and probable reward of staying true to the value discipline during the cycle extremes. We suggest, among other things, that while Buffett was smart to switch from Graham-type asset-based investing to sustainable earnings-based investing in the early 80s when few others did so, now that everyone is forecasting strong future earnings, maybe this is a good time to be one of the few scooping up cheap assets. To paraphrase Buffett, it's like being a kid in a candy shop.

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