



# How to Make Money in Value Stocks

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Everything you need to get started in Value Investing

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# Chapter 1: What is value investing?

*“Nowadays people seem to know the price of everything and the value of nothing.” Oscar Wilde*

Stock market investors can broadly be defined as fitting one of a handful of categories, among them: value, growth, momentum and income. There are a thousand analysts who would beg to differ on that simplification so we will qualify it by saying that there are off-shoots to all of those categories, and in some cases it's difficult to try and separate them. After all, who wouldn't want to buy a cheap stock? And who wouldn't be on the look out for a business, and a stock price, that will grow?

Nevertheless, at its core, the value investing school is a distinct philosophy which involves searching for what is out of favour in order to find a bargain.

## **Value investing is simple...**

For investors that are about to embark on a value investing strategy, there are two pieces of good news. The first is that bargain hunting, or buying dimes for nickels, or however you like to view it, is among the most clear-cut strategies in investing. No-one can argue about the objective or the intended result – it is the search for cheap stocks that have been mispriced and will eventually rise in value and deliver a profit.

The second piece of good news is that there are really only a handful of key principles that a successful Value Investor needs to focus on

when considering a purchase. Firstly, what is the stock's intrinsic value (or how much is it really worth?) and secondly, are you leaving yourself a wide enough margin of safety to protect yourself from the vagaries of unknowns to ensure a good return?

So the basics are... pretty basic. If you compare the price of a stock with your confident valuation of its true worth and find you can buy it comfortably lower than your required margin of safety then you may be on to a winner.

### **...but it's not easy...**

While that may all sound simple, value investing is much harder than it looks because it runs against almost all human instincts. Investors feel safest when buying the same stocks as everyone else and have a tendency to favour glamour stocks in fast growing industries. Who wants to be the guy holding the bombed out engineering stocks when everyone else is buying Apple?

It is hard to develop a conviction about buying companies experiencing hard times, operating in mature industries, or facing similarly adverse circumstances and even harder to hold onto them in the face of consensus opinion and market volatility.

## **Which is precisely why it works**

But it's precisely these behavioural tendencies that lead to so many investors over-reacting and driving prices down so low in value stocks. It is this over- reaction that leads to under-valuation which in turn provides the profit- making opportunity for the Value Investor.

As a result, the aspiring Value Investor must become immune to these emotions and learn to be highly contrarian and stoic in nature,

buying when the irrational ‘Mr Market’ is selling and selling when he starts to agree with him. It is this contrarian nature that leads to significant payoffs as we shall see.

## **There are many approaches to harvesting value profits**

In the coming chapters, we will explore each of these key principles and ideas in greater detail, identify some shortcuts to finding value stocks and consider five different value investing strategies that have been developed by some of the world’s most successful investors. Value Investors can be broadly defined as fitting one of two distinct categories depending on how they tackle the job at hand – they are either ‘value hunters’ or ‘value farmers’. While hunters such as Warren Buffet focus on making large, highly focused bets on single stocks, the farmers take these value investing ideas and apply them in a broader portfolio fashion in order to ‘harvest’ value-based profits from the market in a systematic fashion.

While contradictory, these approaches have been shown to be equally successful in generating profits for their adherents and as a result will ensure that their authors - including Ben Graham, Joseph Piotroski, Josef Lakonishok, Joel Greenblatt and Warren Buffett - will continue to be hugely influential figures in investing circles.

But before we get into the detail of the techniques, it will pay dividends to dig into the track record of value investing’s most famous sons. The frankly astonishing profits of this group of investors illustrate why value investing is the King of all stock market strategies.