

Is Value Investing Dead?

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One principle of value investing has always been mean reversion. If you buy something for less than its worth, eventually the market will notice and push the price up. The key question of course is how do you measure 'worth'. In 1934 when Benjamin Graham wrote *Security Analysis*, his definition of worth was based on the physical assets held by the business. If the company was selling below its liquidation value, you had a margin of safety. Graham measured liquidation value using the book value or net current asset value (current assets less total liabilities). His thinking was likely influenced by the Great Depression which caused him to be overly cautious.

However, the economy has changed a lot over the years. Back then, a majority of a stock's value was tied to its tangible book value. Intangible assets now account for over 80% of the average company's market value.

Companies had fewer competitive advantages in an asset heavy economy because a competitor could come along and steal market share by simply acquiring a similar asset base. If you were in the business of making plastics and a salesman convinced you to buy a new piece of machinery that would increase production, you would have been very excited. This excitement would be short lived after you realised the salesman managed to convince your competitors to buy the same machine. In a competitive market where the products were undifferentiated, you had no choice but to pass savings back to the customer.

The increasing importance of intangible assets like brands changed everything. Now you had an asset that could not be easily replicated by your competitors. In an asset heavy economy, buying stocks at a discount to book value was a good strategy because mean reversion was likely to return prices back to book value. In an asset light economy, expecting price to book values to mean revert doesn't make sense because a company can increase its real economic value without increasing its tangible assets.

The increased importance of intangible assets such as brands, patents, R&D and how they are treated by accountants has led to distortions of traditional value metrics such as low P/E or P/B ratios.

Prior to 1975, companies in the USA could capitalise R&D spend. This meant that investing \$1 billion into developing a new product or process was not immediately expensed on the income statement. Instead it was capitalised on the balance sheet and amortised over a fixed amount of time. Today, GAAP accounting (used in the USA) requires R&D to be expensed so a \$1 billion investment impacts the income statement straight away and does not appear on the balance sheet. This makes ratios like the P/E and P/B meaningless for companies with lots of intangible assets.

Mean reversion can sometimes sound like a religion to some investors. There is no law of physics that says one variable must mean revert to its historical average. In 1958, the dividend yield on stocks in the U.S. market fell below the long-term bond yield for the first time in history. Many people saw this as a sign of an expensive market and expected the dividend yield to revert to historical averages. They have been wrong for 60 years and counting.

Mean reversion needs to be understood in the context of changes in the economy like the larger importance of intangible assets and how current accounting principles can distort true economic value.

Value investing is still very much alive but simply using a low multiple as an indication of value can't be applied to companies with lots of intangible assets. Value investing is simply buying something for less than its worth. The principle remains the same but the measure of worth has changed for many companies.

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