Value Investing

By Amy Fontinelle

Table of Contents
1) Value Investing: Introduction
2) Value Investing: What Is Value Investing?
3) Value Investing: How Stocks Become Undervalued
4) Value Investing: Finding Undervalued Stocks
5) Value Investing: Finding Value In Financial Reports And Balance Sheets
6) Value Investing: Finding Value In Income Statements
7) Value Investing: Managing The Risks In Value Investing
8) Value Investing: Famous Value Investors
9) Value Investing: Couch Potato Value Investing
10) Value Investing: Common Alternatives To Value Investing
11) Value Investing: Conclusion

Value Investing: Introduction

Investors are often looking for ways to beat the market. If you’re one of those investors, you should consider following a proven strategy that has been implemented by the investment greats. Value investors figured out how to beat the average annualized returns of the S&P 500 a long time ago, and many have successful track records spanning several decades to prove it. The most famous value investor, of course, is Warren Buffett, but there are many others, including Benjamin Graham, David Dodd, Charlie Munger, Christopher Browne and Seth Klarman.

If you’re an avid sale shopper, you already have some of the most important skills a value investor needs. You know that the time to buy a 12 pack of soda is not when it’s regularly priced at $6. Perhaps the soda is, in fact, worth $6, but you know that if you wait for the right opportunity you can get it for less. The right
time to buy soda is not even when it is on sale for $4. No, you want to wait until
the soda sales cycle hits a low and you can purchase a 12 pack for just $2. Then,
you’ll buy enough soda to last you several months, or maybe even the whole
year. You’ll be getting a $6 value for just $2.

Apply this idea to stocks and you have value investing, plain and simple. Any
time you buy a stock, you want its intrinsic value to be higher than its market
price. If you have the right temperament and you’re willing to put in the effort, you
can learn how to successfully invest in individual stocks using value investing
techniques. This tutorial will help you get started. (To learn more, refer to The
Value Investor’s Handbook.)

**Value Investing: What Is Value Investing?**

Unlike some investment strategies, value investing is pretty simple. It doesn’t
require that you have an extensive background in finance (although
understanding the basics will definitely help), sign up for an expensive
subscription service or understand how to analyze squiggly lines on charts. If you
have common sense, patience, money to invest and the willingness to do some
reading and accounting, you can become a value investor. Here are five
fundamental concepts you’ll need to understand before getting started.

**Value Investing Fundamental No. 1: Companies Have Intrinsic Value**
The basic concept behind value investing is so simple that you might already do
it on a regular basis. The idea is that if you know the true value of something you
can save a lot of money if you only buy things when they’re on sale.

Most folks would agree that whether you buy a new TV when it’s on sale or when
it’s at full price, you’re getting the same TV with the same screen size and the
same picture quality. The obvious assumption that we have to make is that the
value of the TV will not depreciate with time as new technology becomes
available. Stocks are the same way: the company’s stock price can change even
when the company’s intrinsic value is the same. Stocks, like TVs, go through
periods of higher and lower demand. These fluctuations change prices, but they
don’t change what you’re getting.

Many savvy shoppers would argue that it makes no sense to pay full price for a
TV since TVs go on sale several times a year. Stocks work the same way. The
only difference is that, unlike TVs, stocks will not be on sale at predictable times
of year like Black Friday and their sale prices won’t be advertised. If they were,
stocks on sale would be less of a bargain because more people would know
about the sale and drive the price up. If you’re willing to do the detective work to

This tutorial can be found at: http://www.investopedia.com/university/value-investing/default.asp
find these secret sales, you can get stocks at bargain prices that other investors will be oblivious to.

**Value Investing Fundamental No. 2: Always Have a Margin of Safety**

Buying stocks at bargain prices gives you a better chance at earning a profit later when you sell them. It also makes you less likely to lose money if the stock doesn’t perform as you hope. This principle, called the **margin of safety**, is one of the keys to successful value investing. Unlike speculative stocks whose price can plummet, it is less probable that value stocks will continue to experience price declines.

You might already apply this principle when you shop. When you buy new clothes, maybe you don’t like to pay full price because sometimes an article of clothing just doesn’t work out. It might look good and feel comfortable in the store, but then when you wear it in real life, it feels too tight or too loose or it fades or shrinks in the washing machine. If you buy a shirt on sale for $20 instead of buying it at full price for $60, you will only lose $20 on a bad shirt purchase. If you pay $60, your loss will be significantly greater. By purchasing the shirt on sale for $20, you limit your potential loss. On the other hand, you might end up wearing the shirt a hundred times, making it a great bargain at only $20. Either way, you’re better off buying the shirt for $20 than for $60. Of course, unlike stocks, your clothes won’t appreciate in value and you won’t sell them for a profit later.

Value investors implement the same sort of reasoning. If a stock is worth $100 and you buy it for $66, you’ll make a profit of $34 simply by waiting for the stock’s price to rise to the $100 it’s really worth. On top of that, the company might grow and become more valuable, giving you a chance to make even more money. If the stock’s price rises to $110, you’ll make $44 since you bought the stock on sale. If you had purchased it at its full price of $100, you would only make a $10 profit. Benjamin Graham, the father of value investing, only bought stocks when they were priced at two-thirds or less of their intrinsic value. This was the margin of safety that he felt was necessary to earn the best returns while minimizing investment downside.

**Value Investing Fundamental No. 3: The Efficient-Market Hypothesis Is Wrong**

Value investors don’t believe in the **efficient-market hypothesis**, which says that stock prices already take all information about a company into account. Value investors believe that sometimes stocks are underpriced or overpriced. For example, a stock might be underpriced because the economy is performing poorly and investors are panicking and selling all their stocks (think Great
Recession). Or it might be overpriced because investors have gotten overly excited about a new technology that hasn’t proven itself yet (think dot-com bubble).

**Value Investing Fundamental No. 4: Successful Investors Don’t Follow the Herd**

Value investors possess many characteristics of contrarians - they don’t follow the herd. Not only do they reject the efficient-market hypothesis, but when everyone else is buying, they’re often selling or standing back. When everyone else is selling, they’re buying or holding. Value investors don’t buy the most popular stocks of the day (because they’re typically overpriced), but they are willing to invest in companies that aren’t household names if the financials check out. They also take a second look at stocks that are household names when those stocks’ prices have plummeted. Value investors believe companies that offer consumers valuable products and services can recover from setbacks if their fundamentals remain strong.

Value investors only care about a stock’s intrinsic value. They think about buying a stock for what it actually is - a percentage of ownership in a company. They want to own companies that they know have sound principles and sound financials, regardless of what everyone else is saying or doing.

**Value Investing Fundamental No. 5: Investing Requires Diligence and Patience**

Value investing is a long-term strategy - it does not provide instant gratification. You can’t expect to buy a stock for $66 on Tuesday and sell it for $100 on Thursday. In fact, you may have to wait years before your stock investments pay off. (The good news is that long-term capital gains are taxed at a lower rate than short-term investment gains.)

What’s more, value investing is a bit of an art form - you can’t simply use a value-investing formula to pick the right stocks which fit the desired criteria. Like all investment strategies, you must have the patience and diligence to stick with your investment philosophy even though you will occasionally lose money.

Also, sometimes you’ll decide that you want to invest in a particular company because its fundamentals are sound, but you’ll have to wait because it’s overpriced. Think about when you go to the store to buy toilet paper: you might change your mind about which brand to buy based on which brand is on sale. Similarly, when you have money saved up to invest in stocks, you won’t want to buy a stock just because it represents a share of ownership in your favorite company - you’ll want to buy the stock that is most attractively priced at that
moment. And if no stock is particularly well priced at the moment, you might have to sit on your hands and avoid buying anything. (Thankfully, stock purchases, unlike toilet paper purchases, can be postponed until the time is right.)

Next, we'll discuss how stocks become undervalued.

**Value Investing: How Stocks Become Undervalued**

If you don't believe in the efficient market hypothesis, you can find a number of reasons why stocks might be trading below their intrinsic value. Many of these factors interact with one another to drag a stock's price down or to push it up beyond what it should be. Here are a few.

**Market Momentum and Herd Mentality**

People invest irrationally based on psychological biases rather than analysis of market fundamentals. They buy when the price of a particular stock is rising or when the value of the market as a whole appears to be rising. They don't want to miss out on the gains that they assume others are achieving. They see that if they had invested 12 weeks ago, they could have earned 15% by now. They don't want to miss out on future increases of the same magnitude. They hear other people bragging about their paper profits and they want in. Likewise, when the price of a particular stock is declining or when the value of the market as a whole appears to be falling, myopic loss aversion forces most people to sell their stocks. They don't want to lose everything, and they're afraid of the uncertain. So instead of keeping their losses on paper and waiting for the market to change directions, they accept a certain loss by selling. Such investor behavior is so widespread that it affects the prices of individual stocks, exacerbating downward market movements. (Such behavior also has a dramatic, negative effect on the portfolio returns of people who invest this way.)

- **Bubbles and Market Crashes**
  
  When market momentum and the herd mentality run to extremes, bubbles and crashes result. The early 2000s tech bubble and the mid-2000s housing bubble were fueled by dramatic levels of overinvestment that bid up the prices of tech stocks and real estate beyond what the underlying companies and properties were worth. When the unsustainable highs began to fall, investors panicked and a crash ensued, causing some stocks to be priced closer to their true values and others to fall below their true values. (Bubbles are deceptive and unpredictable, but by studying their history we can prepare to our best ability. Check out [5 Steps Of A Bubble](http://www.investopedia.com/university/value-investing/default.asp).)
• **The Stock Is Unnoticed**  
Companies might sell for less than they’re worth because they’re under the radar. **Small cap** stocks, foreign stocks, and any other stocks that aren’t in the headlines or aren’t household names sometimes offer great potential but don’t get the attention they deserve.

• **The Stock Isn’t Glamorous**  
Everyone wants to invest in the next big thing or even the current big thing. Not only do investors think they can make a fortune this way, but it’s a lot more exciting to say you became a millionaire by purchasing shares of a technology startup than by purchasing shares of an established consumer durables manufacturer. Media darlings like Microsoft, Apple and Google are more likely to be affected by herd mentality investing than **conglomerates** like Proctor and Gamble or Johnson and Johnson.

• **A Company Announces Bad News**  
Even good companies face setbacks like litigation and recalls. However, just because a company experiences one negative event doesn’t mean that the company isn’t still fundamentally valuable or that its stock won’t bounce back. Companies with real value can experience a significant drop in share price when something bad happens. However, investors often overreact to the magnitude of the information, opening up buying opportunities for value investors who strictly follow fundamental principles. Those who are willing to consider the company’s long-term value and ability to recover can turn these setbacks into profit opportunities.

• **One Part of the Company Is Underperforming, but Other Parts Are Still Strong**  
Sometimes a company has an unprofitable division that drags down its performance. If the company sells or closes that division, its financials can improve dramatically. Value investors who see this potential can buy the stock while its price is depressed and see gains later.

• **The Stock Doesn’t Meet Analysts’ Expectations.**  
Analysts do not have a great track record for predicting the future, and yet investors often panic and sell when a company announces earnings that are lower than analysts’ expectations. This irrational behavior can temporarily depress a stock’s price.

• **The Stock Is Cyclical**  
It’s common for companies to go through periods of higher and lower
profits. The time of year and the overall economy affect consumers’ moods and cause them to buy more or less. Their behavior might affect the stock’s price, but it has nothing to do with the company’s long term underlying value.

For these and other reasons, stock prices can become depressed despite that the company continues to create value for its shareholders. Such situations present profit opportunities for value investors.

In the next section, we’ll talk about how to find undervalued stocks.

**Value Investing: Finding Undervalued Stocks**

There are two basic steps to finding undervalued stocks: developing a rough list of stocks you want to investigate further because they meet your basic screening criteria, then doing a more in-depth analysis of these stocks by examining the financial data of the selected companies.

The internet has made it easy, fast and free to find the information you need to value a company’s stock. You can search for a company’s financials through online databases such as Edgars and Sedar or find quarterly reports and press releases on the company’s official website. Major financial website (including Investopedia.com) allow investors to get information such as stock price, shares outstanding, earnings per share and current news regarding the company/industry. You can also see who the stock’s largest owners are, which insiders have placed trades recently and how many shares they traded. Some websites will also filter stocks according to criteria you set, such as stocks with a certain P/E ratio. These filters can help you come up with a broad list of stocks that you want to research further.

Recall Benjamin Graham’s rule that an undervalued stock is priced at least a third below its intrinsic value. So how do you determine a company’s intrinsic value, especially if you didn’t go to business school and have no idea how to value a company? Open your spreadsheet software and we’ll perform some simple calculations with stock data you can find online.

**Basic Value Investing Ratios**

- **P/E Ratio**
  You’ve probably heard financial analysts comment that a stock is selling for some number “times earnings,” such as 30 times earnings or 12.5 times earnings. This means that P, the price the stock is currently trading
at, is 30 times higher than E, the company’s annual earnings per share, or EPS. However, for now, all you need to know is that value investors like the P/E ratio to be as low as possible, preferably even in the single digits. The number that results from calculating P/E is called the earnings multiple. So a stock that sells for $50 (P) and generates $2 EPS (E) would have an earnings multiple of 50/2, or 25. A value investor would normally pass on this stock. (For more information, read *Investors Beware: There Are 5 Types Of Earnings Per Share.*)

- **Earnings Yield**
  Earnings yield is simply the inverse of the earnings multiple. So a stock with an earnings multiple of 5 has an earnings yield of 1/5, or 0.2, more commonly stated as 20%. Since value investors like stocks with a low earnings multiple and earnings yield is the inverse of that number, we want to see a high earnings yield. Primarily a high earnings yield tells investors that the stock is able to generate a large amount of earnings relative to the share price.

Some of the information that will help you find undervalued stocks does not require you do to any math, but it does require you to do research beyond the stock quote.

**Insider Purchasing Activity**
For our purposes, insiders are the company’s senior managers and directors and any shareholders who own at least 10% of the company’s stock. A company’s managers and directors have unique knowledge about the companies they run, so if they are purchasing its stock, it’s reasonable to assume that the company’s prospects look favorable.

Likewise, investors who own at least 10% of a company’s stock wouldn’t have bought so much if they didn’t see profit potential. If they’re buying even more, they must be seeing greater profit potential. (To learn more, read *What Investors Can Learn From Insider Trading.*)

On the other hand, a sale of stock by an insider doesn’t necessarily point to bad news about the company’s anticipated performance—the insider might simply need cash for any number of personal reasons. Nonetheless, if mass sell-offs are occurring by insiders, such a situation may warrant further in depth analysis of the reason behind the sale.

How do you know what insiders are doing with their stock holdings? Insiders are required to report their stock purchases to the SEC within 2 business days. This

*This tutorial can be found at: http://www.investopedia.com/university/value-investing/default.asp*
information is freely available through the SEC website and is reported on SEC form 4. It is also often available through various financial websites which aggregate this information.

The Art Of Value Investing
The key to buying an undervalued stock that is actually worth more than it is currently trading for is to thoroughly research the company and not just buy a stock because a few of its ratios looks good or because its price has recently dropped. It’s not quite that simple to tell if a stock is a good buy. Applying your common sense and critical thinking skills to stock selection is essential.

Value investor Christopher H. Browne of the legendary value-investing firm Tweedy, Browne recommends asking a series of questions about a company in his book “The Little Book of Value Investing.” Think about the company’s future prospects - can the company increase its revenue by raising prices? Increasing sales? Lowering expenses? Selling or closing unprofitable divisions? Growing the company? Who are the company's competitors and how strong are they?

What you think the answers to these questions are is where value investing becomes a bit of an art form. It’s also why you can’t just plug some numbers into a software program to determine the best stocks to invest in.

To increase your odds of accurately answering these questions, it’s wise to buy companies that you understand. Warren Buffett takes this approach. Companies that you understand will most likely be those in industries you have worked in or sell consumer goods products that you are familiar with. If you’ve worked for a biotech company for several years, you probably have a better-than-average understanding of the biotechnology business. And if you buy basic items like cars, clothes, appliances and food, you know a thing or two about consumer goods.

Well known investor Peter Lynch strongly advocated such a strategy whereby retail investors can outperform institutions simply by investing in what they know before Wall Street catches on.

Another strategy that value investors favor is to buy companies whose products or services have been in demand for a long time and are likely to continue to be in demand. Looking at stock quotes won’t tell you which companies these are—you’ll have to do some critical thinking. Of course, it is not always possible to predict when innovation will make even a longstanding product or service obsolete, but we can find out how long a company has been in business and research how it has adapted to change over time. At this point it may be
worthwhile to analyze management and the effectiveness of corporate governance to determine how the firm reacts to changing business environments.

Next, we'll talk about how to use the information in companies’ financial statements to find undervalued stocks.

**Value Investing: Finding Value In Financial Reports and Balance Sheets**

There is plenty of information about a company that you'll want to know as a value investor but that you can’t get from a casual glance at a stock quote or from reading most stock market commentary. In this section, we'll tell you where to find that information and what to look for.

**Financial Reports**

Financial reports are a company’s annual and quarterly performance results. The annual report is SEC form 10-K and the quarterly report is SEC form 10-Q. Companies are required to file these reports with the Securities and Exchange Commission (SEC). You can find them at the SEC website or at the company’s corporate or investor relations website.

You can learn a lot from a company’s annual report. It will explain what products and/or services the company sells and give you an idea of how the company sees itself. For example, most people think of books when they think of Amazon.com. However, Amazon’s annual report says, “We seek to be Earth’s most customer-centric company for three primary customer sets: consumers, sellers, and enterprises. In addition, we generate revenue through other marketing and promotional services, such as online advertising, and co-branded credit card agreements.” This statement tells investors that the company has a much broader focus than books. A company’s financial reports will also describe its recent major accomplishments, changes in leadership, risk factors, intellectual property, any regulatory changes that affect the company and more.

If you’re interested in investing in a company but you’re not sure you understand its business model, try reading the annual report—it might be eye-opening. For example, you might not think of yourself as someone who would invest in a pharmaceutical company, but when you read its annual report and learn about what its major drugs are, why people need them and how they work, you might discover that you understand more than you expected to. However, if you’re still lost after doing this research, you should probably pass on the stock.
Of course, financial reports also provide the financial data that investors want to analyze, such as revenues, operating expenses, net income, total assets, total debt and more. Financial reports also make it easy to compare these numbers across time by providing historical data along with current data. For example, a look at Amazon’s 2010 10-K shows that Amazon’s net sales have increased every year for the last five years, from $10,711 million in 2006 to $34,204 million in 2010. If you want to go back further in time, you can also look up older annual reports. Historical data should be analyzed to determine the effectiveness of growth prospects and to create forecasts.

Financial reports can also tell you a lot about the company’s weaknesses. Amazon’s 2010 annual report says, for example, “We Have a Rapidly Evolving Business Model and Our Stock Price Is Highly Volatile,” “We May Be Subject to Product Liability Claims if People or Property Are Harmed by the Products We Sell,” and “We Could Be Liable for Fraudulent or Unlawful Activities of Sellers.” As a potential investor, you will want to think about how much of a threat these weaknesses are to your likelihood of earning a profit.

An essential component of any financial report is the company’s financial statements. We’ll examine two - the balance sheet and the income statement - that will give you many of the numbers you’ll need for your value investment analysis.

The Balance Sheet
A company’s balance sheet provides a big picture of the company’s financial condition. The balance sheet consists of two sections, one listing the company’s assets and another listing its liabilities and equity.

The assets section is broken down into a company’s cash and cash equivalents; investments; trade receivables or accounts receivable; inventories; deferred tax assets; intangible assets; goodwill; property, plant and equipment; and other assets. These subcategories won’t be identical for every company you examine because different companies have different types of assets.

The liabilities section lists the company’s accounts payable, accrued liabilities, convertible notes, long-term debt, other non-current liabilities, and any other outstanding debts that the company may have. The shareholders equity section of the balance sheet reflects how much money is invested into the company in addition to the cumulative retained earnings. Again, these subcategories won’t be identical for every company you examine because different companies have different types of liabilities. (For example, an insurance company might list “unearned premiums” as a liability, but a food service company would not.)
One important ratio that value investors like to calculate using balance sheet data is called the **current ratio**. The current ratio compares the company’s total current assets to its total current liabilities. Current assets will be utilized within a year and current liabilities must be covered within the same time frame.

The higher the ratio, the better, but value investors like to see a current ratio of at least 2 to 1, meaning that the company has at least twice as many current assets as current liabilities. The current ratio indicates how easily a company can cover its current obligations and reveal the general liquidity position of the firm. Comparing a company’s current ratio for the most recent year to that of previous years and to that of similar companies for the same years will help you put this number into perspective.

For some calculations, you can let someone else do the math for you—Yahoo! Finance, for example, provides the current ratio and many other important metrics under a category called “Key Statistics” when you look up a company’s ticker symbol.

While you’re at it, you can also calculate **net current assets per share**. To get net current assets (also called working capital or current capital), you subtract current liabilities from current assets. Divide the result by the number of shares outstanding and you get net current assets per share. (You can find a company’s shares outstanding through the company’s financial statement – specifically the income statement.) A lower net current asset per share figure is considered a green light for value investors to continue with the analysis.

The balance sheet also provides a snapshot of a company’s long-term finances. Long-term assets may be lumped together under a term like “fixed assets” or “property, plant and equipment.” Included in these categories are assets such as the real estate and factories the company owns. “Intangible assets” is also a long-term asset; it attempts to measure the value of the company’s intellectual property holdings (copyrights, trademarks and patents). Long-term liabilities are a company’s financial obligations whose maturity is longer than one year, including real estate leases and bond issues.

Another important number to get from the balance sheet is the company’s debt-to-assets ratio. To get this number, divide total liabilities by total assets. (Note that the term “debt” is used very loosely in this ratio because it includes all of a company’s liabilities, not just its long term debt.) Graham avoided companies whose debt exceeded 50% of assets. The lower the company’s debt ratio, the better. (Read [The Debt Ratio](http://www.investopedia.com/university/value-investing/default.asp) to learn more.)
Book value per share and price-to-book ratio are also meaningful. Book value is the company’s net worth—its assets minus its liabilities. The book value per share statistic is obtained by dividing the company’s net worth by the number of shares outstanding. Value investors are interested in companies when their stock price is below book value per share. If a company has a net worth of $10 million and it has 500,000 shares outstanding, its book value per share is $10,000,000 / 500,000, or $20. If the stock is trading for $15, it may be worth researching further. Comparing the $15 stock price to the $20 book value gives us the price-to-book ratio. ($15/$20 = 0.75)

These aren’t the only financial ratios you can calculate using the numbers on the balance sheet, but they are a few of the most basic ones. (For further reading, see Reading The Balance Sheet and our Financial Ratio Tutorial.)

If a company’s balance sheet doesn’t check out or if you can’t understand it, cross the stock off your list and move on.

Next, let’s look at what you can learn from income statements.

Value Investing: Finding Value In Income Statements

A company’s income statement basically tells you how much money it has taken in and how much it has paid out over a year or a quarter. Looking at the annual income statement rather than a quarterly statement will give you a better idea of the company’s overall position since many companies experience fluctuations in sales volume over the course of the year.

The first item on the income statement tells you how much money the company received from selling its products and/or services to its customers. This figure may be labeled “revenues,” “net sales,” “net operating revenues,” or something similar. By comparing the current year’s figure to previous years’ figures, you can see if the company’s sales are improving over time. Increasing sales also indicate that the company is growing. Amazon reported net sales of $24,509 million in 2009, for example, and this represented a significant increase over the $19,166 million it reported in 2008 and the $14,835 million it reported in 2007. (Though Amazon would be considered a growth stock, not a value stock, we’re using it as an example here because everyone is familiar with the company and its financial statements are easy to read.)

Next, the income statement gets into the company’s expenses. This second line might be called “cost of products sold,” “cost of goods sold,” “cost of sales,” “cost
of services,” or some variation thereof. Subtracting the cost of revenue from the actual revenue generated produces the gross profit. In other words, how much revenue does the company actually earn after subtracting the cost to produce what it sells? Amazon reported cost of revenue at $18,978 for 2009. (All the numbers on the income statement are in millions, but the numbers are rounded and zeroes are dropped to keep things simple.) Subtracting this figure from $24,509 yields a gross profit of $5,531 million.

There are more expenses to account for, however, and gross profits must be high enough to cover them and leave a net profit. Companies have selling, general and administrative expenses (SG&A). Sometimes companies call these “selling, marketing and administrative expenses,” or they might break the category down and list marketing expenses separately from general and administrative expenses. Some companies, like biotech companies, have research and development expenses in addition to SG&A. Amortization and depreciation are also considered operating expenses. Look at the company’s expenses over time. If expenses are increasing, that isn’t necessarily a bad thing if revenues are also increasing at a higher rate. However, you don’t want to see expenses increasing over time as a percentage of revenues—you want to see them holding steady or decreasing as a percentage of revenues.

Subtracting total operating expenses from gross profit gives you the company’s operating income. Amazon’s total operating expenses for 2009 were $4,402 and included fulfillment, marketing, technology and content, general and administrative, and other. Subtracting $4,402 in operating expenses from $5,531 in gross profits left Amazon with $1,129 million in operating income.

After subtracting interest expenses and income taxes from operating income in addition to making any other company specific adjustments, you get the company’s net income, also called net earnings. This number is the “bottom line.” For 2009, Amazon’s net income or bottom line was $902 million.

Finally, the last lines of the income statement present the company’s basic earnings per share and diluted earnings per share. Basic EPS divides net income by number of shares outstanding. Some companies describe shares outstanding as “basic average shares outstanding” or “shares used in calculation of earnings per share.” Amazon’s weighted average shares outstanding through 2009 amounted to 433 million. If we divide $902 million of earnings by 433 million shares outstanding, we get basic earnings per share of $2.08. Thankfully, we don’t actually have to do the math because most companies do it for us in the financial reports. Analysts and investors are always looking for earnings per share growth.
The income statement also presents figures for diluted earnings per share. Most companies issue convertible securities such as stock options, convertible bonds, preferred stock and warrants. Diluted EPS represents earnings per share if all these financial instruments were converted to shares. If convertibles are turned into shares, there will be more total shares outstanding and each stockholder will own a smaller percentage of the company. Owning a smaller percentage of the company means owning a smaller percentage of the profits. Diluted EPS will thus be lower than basic EPS, but value investors want this difference to be small.

The income statement also shows how the number of shares outstanding has changed over time. Amazon’s 2009 10-K, for example, shows that its basic shares were 423 million in 2008, 433 in 2009, and 447 in 2010. Although growth companies will typically increase the number of outstanding shares on a yearly basis, value stocks have a decreasing number of shares. When the number of shares decreases, reflecting share buyback programs, this activity is a good sign that indicates management’s confidence in the company’s future performance. It also means that each share of the company’s stock is entitled to a higher percentage of earnings. On the other hand, if shares outstanding are increasing, it could mean that the company is handing out lots of stock options, which will dilute your earnings, or that the company is raising more money through stock offerings.

Now that we understand what the numbers on the income statement mean, we can use them to calculate the most basic measures of profitability. Profit margin can be a more helpful indicator of a company’s performance than net sales or net revenue because it takes costs into account. There are two types of profit margin: net and gross. Calculated as a percentage, net profit margin divides net profit by sales, while gross profit margin divides gross profit by sales. Remember, the numbers you need for these calculations are located at bottom and top of the income statement. For 2009, Amazon’s gross profit margin was 5,531 / 24,509 = 22.57%; its net profit margin was $902 / 24,509 = 3.7%.

A low profit margin can indicate that a company’s costs are too high or that the market won’t support a high enough price for its products and services. However, there is not an absolute number that is considered a good profit margin; what is considered good depends on the industry the company belongs to. Comparing a company’s profit margins to those of its competitors can provide some indication of whether the company has a good profit margin and how the company may perform long term. Comparing a company’s most recent year’s profit margin to its previous year’s profit margins tells you how the company is performing over time. Value investors want to see a company’s profit margin be higher than that of its
competitors, and they want the companies they invest in to have consistent or increasing profit margins over time.

Remember, value investors are long-term investors, so it’s important that when you look at a company’s income statement, you see long-term profitability.

With all the information you have learned how to gather in this chapter and the previous chapter, you can now compare the stock you’re interested in to others like it. Value investors find it especially helpful to compare stocks they’re considering to those of similar companies that have recently been acquired. The price a stock sells for in an acquisition often accurately reflects the company’s true value since acquisitions are transacted by well-informed investors. (These deals can make or break investors’ returns. Find out how to tell the difference. See Analyzing An Acquisition Announcement.)

No matter how much research you do, though, value investing, like all types of investing, is not foolproof. In the next section, we’ll discuss some of these risks and how to manage them.

Value Investing: Managing The Risks In Value Investing

Although value investing properly executed is a low-to-medium-risk strategy, it still comes with the possibility of losing money. This section describes the key risks to be aware of and offers guidance on how to mitigate them.

a. Basing Your Calculations on the Wrong Numbers
Since value investing decisions are partly based on an analysis of financial statements, it is imperative that these calculations be performed correctly. Using the wrong numbers, performing the wrong calculation or making a mathematical typo can result in basing an investment decision on faulty information. Such a mistake could mean making a poor investment or missing out on a great one. If you aren’t yet confident in your ability to read and analyze financial statements and reports, keep studying these subjects and don’t place any trades until you’re truly ready. (For more on this, check out our Financial Statements Tutorial.)

b. Overlooking Extraordinary Gains or Losses
Some years, companies will experience unusually large losses or gains from events such as natural disasters, corporate restructuring or unusual lawsuits and will report these on the income statement under a label such as “extraordinary item – gain” or “extraordinary item – loss.” When making your calculations, it is important to remove these financial anomalies from...
the equation to get a better idea of how the company might perform in an ordinary year. However, think critically about these items, and use your judgment. If a company has a pattern of reporting the same extraordinary item year after year it might not be too extraordinary. Also, if there are unexpected losses year after year, this can be a sign that the company is having financial problems. Extraordinary items are supposed to be unusual and nonrecurring. Also beware a pattern of write-offs.

c. Ignoring the Flaws in Ratio Analysis
Earlier sections of this tutorial have discussed the calculation of various financial ratios that help investors diagnose a company’s financial health. The problem with financial ratios is that they can be calculated in different ways. Here are a few factors that can affect the meaning of these ratios:
- They can be calculated with before-tax or after-tax numbers.
- Some ratios provide only rough estimates.
- A company’s reported earnings per share (EPS) can vary significantly depending on how “earnings” is defined.
- Companies differ in their accounting methodologies, making it difficult to accurately compare different companies on the same ratios. (Learn more about when a company recognizes profits in Understanding The Income Statement.)

d. Overpaying
One of the biggest risks in value investing lies in overpaying for a stock. When you underpay for a stock, you reduce the amount of money you could lose if the stock performs poorly. The closer you pay to the stock’s fair market value—or even worse, if you overpay—the bigger your risk of losing capital. Recall that one of the fundamental principles of value investing is to build a margin of safety into all of your investments. This means purchasing stocks at a price of around two-thirds or less of their inherent value. Value investors want to risk as little capital as possible in potentially overvalued assets, so they try not to overpay for investments.

e. Not Diversifying
Conventional investment wisdom says that investing in individual stocks can be a high-risk strategy. Instead, we are taught to invest in multiple stocks or stock indexes so that we have exposure to a wide variety of companies and economic sectors. However, some value investors believe that you can have a diversified portfolio even if you only own a small number of stocks, as long as you choose stocks that represent different industries and sectors of the economy. Value investor and investment manager Christopher H. Browne recommends owning a minimum of 10
stocks in his *Little Book of Value Investing*. Famous value investor [Benjamin Graham](https://www.investopedia.com/terms/b/benjamin-graham.asp) suggested 10 to 30 companies is enough to adequately diversify. On the other hand, the authors of *Value Investing for Dummies*, 2nd. ed., say that the more stocks you own, the greater your chances of achieving average market returns. They recommend investing in only a few companies and watching them closely. Of course, this advice assumes that you are great at choosing winners, which may not be the case, particularly if you are a value-investing novice.

**f. Listening to Your Emotions**

It is difficult to ignore your emotions when making investment decisions. Even if you can take a detached, critical standpoint when evaluating numbers, fear and excitement creep in when it comes time to actually use part of your hard-earned savings to purchase a stock. More importantly, once you have purchased the stock, you may be tempted to sell it if the price falls. You must remember that to be a value investor means to avoid the herd-mentality investment behaviors of buying when a stock’s price is rising and selling when it is falling. Such behavior will destroy your returns. (Playing follow-the-leader in investing can quickly become a dangerous game. Learn how to invest independently and still come out on top, read *Logic: The Antidote To Emotional Investing*.)

Value-investing is a long-term strategy. [Warren Buffett](https://www.investopedia.com/terms/w/warren-buffett.asp), for example, buys stocks with the intention of holding them almost indefinitely. He once said “I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years.” You will probably want to sell your stocks when it comes time to make a major purchase or retire, but by holding a variety of stocks and maintaining a long-term outlook, you can sell your stocks only when their price exceeds their fair market value (and the price you paid for them).

**g. Basing Your Investment Decisions on Fraudulent Accounting Statements**

After the accounting scandals associated with Enron, WorldCom and other companies, it would be easy to let our fears of false accounting statements prevent us from investing in stocks. Selecting individual stocks requires trusting the numbers that companies report about themselves on their balance sheets and income statements. Sure, regulations have been tightened and statements are audited by independent accounting firms, but regulations have failed in the past and accountants have become their
clients’ bedfellows. How do you know if you can trust what you read? (For more see Enron's Collapse: The Fall Of A Wall Street Darling.)

One strategy is to read the footnotes. These are the notes in a Form 10-K or Form 10-Q that explain a company’s financial statements in greater detail. They follow the statements and explain the company’s accounting methods and elaborate on reported results. If the footnotes are unintelligible or the information they present seems unreasonable, you’ll have a better idea on whether to pass on the company. (To learn more, read Financial Footnotes: Start Reading The Fine Print.)

h. Not Comparing Apples to Apples
Comparing a company’s stock to that of its competitors is one way value investors analyze their potential investments. However, companies differ in their accounting policies in ways that are perfectly legal. When you’re comparing one company’s P/E ratio to another’s, you have to make sure that EPS has been calculated the same way for both companies. Also you might not be able to compare companies from different industries. If companies use different accounting principles, you will need to adjust the numbers to compare apples to apples; otherwise you can’t accurately compare two companies on this metric. (Fortunately, you can educate yourself on accounting standards and learn how to evaluate earnings quality, read our Earnings Quality tutorial.)

i. Selling at the Wrong Time
Even if you do everything right in terms of researching and purchasing your stocks, your entire strategy can fall apart if you sell at the wrong time. The wrong time to sell is when the market is suffering and stock prices are falling simply because investors are panicking, not because they are assessing the value of the quality of the underlying companies they have invested in. Another bad time to sell is when a stock’s price falls because its earnings have fallen short of analysts’ predictions. (For more bad times to sell your stock, refer back to section 3, How Stocks Become Undervalued.)

The ideal time to sell your stock is when shares are overpriced relative to the company’s intrinsic value. However, sometimes a significant change in the company or the industry that lowers the company’s intrinsic value might also warrant a sale if you see losses on the horizon. It can be tricky not to confuse these times with general investor panic. Also, if part of your investment strategy involves passing on wealth to your heirs, the right time to sell may be never (at least for a portion of your portfolio).
Next, we'll learn the names of some famous value investors and the strategies they've used to succeed.

**Value Investing: Famous Value Investors**

The interesting thing about the value investors who have been especially successful is that they have all achieved extraordinary returns while investing different amounts of money in different stocks at different times. While many of them worked or studied with each other at some point and their basic investment approaches are founded in the same principles, they have achieved their stellar results independently. Here are six value investors whose names you should know.

**Benjamin Graham**

All value investors trace their roots back to Benjamin Graham. Born in 1894, Graham is considered the father of value investing. He authored the two books that form the foundation of value investing theory: *Security Analysis* (with David Dodd) and *The Intelligent Investor*. He developed the idea of buying stocks below their intrinsic value to limit downside risk and promoted the idea that stocks often trade at prices that do not reflect their intrinsic value. Graham's techniques inspired Warren Buffett and have informed Buffett's investment strategy for decades. Graham worked as an investment manager and as a lecturer at Columbia.

**Warren Buffett**

Buffett was born in 1930. He was Graham's student at Columbia and later his employee. Buffett thinks of buying stocks as buying companies (and is wealthy enough that he sometimes buys entire companies), and he has an indefinite time horizon for his investments. He made his first investment at age 14 and became a millionaire by around age 30. Along with Charlie Munger, he purchased a textile company called *Berkshire Hathaway* (NYSE:BRK.A, BRK.B) in 1965 and used the cash flows from the business to invest in companies such as *Coca Cola* (NYSE:KO) and *American Express* (NYSE:AXP) and to purchase entire companies such as GEICO. He has become one of the wealthiest men in the world through value investing. In 2010, Forbes estimated his net worth at $47 billion. (learn more in *Think Like Warren Buffett*.)

**Seth Klarman**

Klarman is the founder of the Baupost Group, which is an investment partnership, and has a history of double-digit returns and beating the S&P 500 since he founded it in 1983. He has achieved these stellar returns even though
he sometimes holds large amounts of cash. As of 2010, his net returns averaged 19% a year and he managed $22 billion. He is risk-averse and bases his value stock picks on companies’ liquidation value. He is also willing to think outside the box and choose investments other than U.S. stocks that other investors might not think to consider or might be afraid of. According to his 2010 Baupost Group letter, the keys to long-term investment success are to have “truly long-term capital; a flexible approach that enables you to move opportunistically across a broad array of markets, securities, and asset classes; deep industry knowledge; strong sourcing relationships; and a solid grounding in value investing principles.” He also believes in looking at what other investors are doing to consider what you can do differently to outperform them.

Walter Schloss
Early in his career, Schloss worked with Buffett at Graham’s firm, Graham-Newman. In 1955, he started his own investment management firm. In 50 years as an investment manager, he averaged about 15% annual returns after fees. He uses company financial statements and the investment publication Value Line for much of his investment research. He looks for companies where management is a major stockholder, debt is low and the stock is trading at a discount to book value. Strategies he has used successfully include shorting stocks and holding large amounts of cash when he didn’t see good investment opportunities. He also diversified beyond what some value investors would recommend, sometimes owning more than 100 stocks at a time. Schloss also never went to college, proving once again that you don’t need a university degree to make lots of money and you don’t need to major in finance to become a great investor.

Christopher H. Browne
Browne worked at Tweedy, Browne Company, an investment firm founded by his father, Forrest Tweedy, for 40 years. Tweedy, Browne’s investment philosophy is based on Graham’s teachings. In fact, Graham traded through the company for three decades. Buffett was also a customer: it was through Tweedy, Browne that he purchased Berkshire Hathaway. The company also had a relationship with Schloss. Initially a brokerage, Tweedy, Browne became an investment firm in 1975 and later developed a handful of value-oriented mutual funds that have outperformed the S&P 500. In 1983 the company started investing in international value stocks. The company’s managing directors pride themselves on owning the same investments that they manage for their clients.

Irving Kahn
Born in 1905, Kahn is yet another Graham disciple - he even worked as his teaching assistant at Columbia. He also contributed to Security Analysis. Along with Graham and other investors, Kahn founded the New York Society of

Kahn started the New York-based private investment firm Kahn Brothers Advisors in 1978 with two of his sons. The company adheres to Graham and Dodd’s margin of safety principle and invests in businesses that are priced below their true value. The managers focus on investments in seasoned businesses in depressed but well-established economic sectors. However, rather than focusing on large cap stocks like Buffett does, Kahn Brothers focuses on small and medium-sized companies and even invests in securities through the over-the-counter market. Like Tweedy, Browne, the firm’s managers purchase the same investments for themselves that they purchase on behalf of their clients. Also, Kahn Brothers’ analysis emphasizes balance sheet data over income statement data. They seek out securities selling at a discount to net working capital per share and adjusted per share book value and that have a low price-to-earnings ratio. (A company’s efficiency, financial strength and cash-flow health show in its management of working capital, check out Working Capital Works.)

In the next section, we’ll discuss options for incorporating value investing into your portfolio without doing all the usual grunt work.

**Value Investing: Couch Potato Value Investing**

At this point, you might be thinking that value investing sounds like a lot of work. You might also be wondering if you really have the patience or skill to do the analysis and pick winning stocks. If so, take heart—it is possible to become a value investor without ever reading a 10-K.

Couch potato investing is a passive strategy of buying and holding a very limited number of low-cost stock and bond index funds. To become a couch potato value investor, you would want to buy and hold a limited number of low-cost value investing vehicles for which usually someone else has done the investment analysis. This section provides several options for pursuing such a strategy. (To learn more about couch potato investing, read Why It Pays To Be A Lazy Investor.)

**Buying Shares of Berkshire Hathaway**

As you probably know, legendary value investor Warren Buffett uses a holding company called Berkshire Hathaway to buy, hold and sell his investments. Since Berkshire Hathaway is a public corporation, ordinary investors can buy shares of it, and it has achieved a compounded annual gain of 20.2% from 1965 to 2010.
according to Buffett’s 2010 annual letter to shareholders. That’s 10.8% more than the S&P 500.

The company issues two classes of shares. The A shares (ticker symbol NYSE: BRK.A) are very expensive, at times trading over $130,000.00 per share in 2011. If you’re not an institutional investor or a very wealthy individual, you’ll want to look at the class B shares (NYSE: BRK.B), which were trading for $79.48 at the time of publication. Class A shares have greater voting privileges and can be converted to class B shares; class B shares have lesser voting privileges and cannot be converted to A shares. For the average investor, the difference in the two share classes is irrelevant. (Learn more in Warren Buffett’s Best Buys.)

Unlike owning value mutual funds or ETFs, there are no ongoing fees associated with owning shares of stock. You will have to pay a small commission any time you place a buy or sell order, but if you buy a large number of shares at once and hold them, your ownership costs become negligible. On the other hand, if you bought one share of BRK.B a month and paid a $7.95 commission each time, you’d be losing 10% of your investment off the bat.

Interestingly, since Berkshire Hathaway is a stock, you could actually apply value investing principles to it and attempt to buy it when it was trading below its intrinsic value. Also investors are always questioning whether the company’s days of amazing returns are over. Buffett himself has said that because the company manages such large amounts of capital, outsized returns are no longer possible, though better than average returns are still the company’s goal. (To learn more about why this might be the case, check out Why Warren Buffett Envies You.)

Coattail Investing
Coattail investors follow the investing behavior of successful investors instead of doing their own research. This approach may be lazy, but it can also be smart. It seriously reduces the time required to track down viable stock picks and can even take the guesswork out of buy and sell timing. So how do you know what successful value investors are doing?

Institutional investment managers with stock portfolios worth $100 million or more must file SEC form 13-F quarterly listing all the securities and the number of shares of each that they hold in their accounts. You can find these filings through the SEC’s online EDGAR database. Just search for the name of the investment company whose holdings you want to research and then do a second search for their 13-F filings. By doing this, for example, you could see that as of December 31, 2010, Berkshire Hathaway’s holdings included Coca-Cola (NYSE: KO),
Johnson & Johnson (NYSE:JNJ), Kraft Foods (NYSE:KFT), Sanofi-Aventis ADR (NYSE:SNY) and a couple dozen other companies.

Once you know what securities your favorite investment manager holds, you can use this list as a jumping off point to perform your own analysis and decide which of those stocks you want to buy. It wouldn’t be wise to just jump into the market and buy all of them because value investing is not just about the companies you own, but about acquiring shares of those companies when they are trading at a discount to their intrinsic value. So if Coca Cola were overvalued at the time of your research, you might determine a price you would be willing to pay for its shares and hold off actually making a purchase until later (perhaps years later) in order to build in your margin of safety. (Discover how to search for potential long term picks in Finding Solid Buy-And-Hold Stocks.)

If you want to mimic not just stocks and timing but also hold the same percentages of each investment in your portfolio, you’ll need to determine what percentage each stock makes up in the investment manager’s portfolio and then apply those percentages to your own significantly smaller pile of investment capital. Keep in mind that the holdings declared on 13-F forms rarely provide a complete picture of an investor’s portfolio, however. You will not be able to find out how much cash they are holding, for example. (More about this in a moment.)

As a coattail investor, you could also try to mimic, as closely as possible, the timing and size of institutional investment managers’ purchases. This is difficult, however, for a couple of reasons. While it is possible to infer trading activity by comparing the previous quarter’s 13-F to the most recent 13-F, this information will always be somewhat out of date. Companies have 45 days after the quarter ends to file form 13-F (and they often take advantage of the full 45-day window), so the information you’re viewing will often be at least 45 days old—and that’s if you read the 13-F the day it comes out. Even though value investing is a buy-and-hold strategy, meaning that there shouldn’t be a great deal of trading activity going on in a value investor’s portfolio, you never know what, when or why they might decide to buy or sell. If you aren’t making the same buy, sell and hold decisions for the same reasons, you might not be able to match their returns. (For more on coattail investing read Build A Baby Berkshire.)

Another problem is that form 13-F does not tell the whole story. If the value investor you are following holds any positions of fewer than 10,000 shares or with a market value of less than $200,000, they won’t appear on form 13-F. Also, not all types of investments must be reported on form 13-F. Only exchange-traded stocks, equity options, warrants, shares of closed-end investment companies, ETFs and some convertible debt securities must be reported. If your favorite
investor owns anything not required to be reported, you aren’t getting the full picture.

It may be possible to learn about their other holdings through research (for example, it is widely known that Seth Klarman, founder of the Baupost Group, isn’t afraid to hold lots of cash), but the information may simply be unavailable. As a result, form 13-F might make it look like 30% of an investment manager’s portfolio is in Coca Cola stock, but if you factored in the unreported assets, it might turn out that they only have 10% of their investment capital allocated to Coca Cola. If you’re not concerned about mimicking allocation percentages and don’t read too much into how many shares of a company an investor owns, this shortcoming of the 13-F may not matter to you.

**Value-Investing Mutual Funds**
Another value-investing method that doesn’t require you to pick individual stocks is to purchase a value-oriented mutual fund. You can find mutual funds that meet your investment criteria in the same way that you find stocks—by using a screening tool. Morningstar is one of the most popular sources for mutual fund data.

Investing in mutual funds can be easy and inexpensive, but there are several tradeoffs and pitfalls to be aware of.

First, mutual fund fees can really eat away at your returns. When you hold a stock long-term, you don’t pay any ongoing fees. When you hold a mutual fund long-term, you pay fees constantly, often without realizing it. To find out how much these fees are, look at the fund’s expense ratio. The expense ratio covers the fund’s advertising, management, administrative, operating and other costs. These days, it is possible to invest in mutual funds with expense ratios as low as 0.1%. If you have invested $1,000, an expense ratio of 0.1% will only cost you $1 a year. (Looking for current mutual fund information? We'll look at one of the places to start your search, see Morningstar Lights The Way.)

That’s no big deal, but as your portfolio increases in size, even a miniscule expense ratio will matter more. If you have $100,000 in that mutual fund, the expenses increase to $100 a year. If you held that same $100,000 in stocks, you would be able to save that $100 a year. Although you would pay stock trading fees, if you’re buying and holding a limited number of companies, these fees probably won’t amount to $100 annually.
Fees
Mutual funds also sometimes have loads, which are percentage fees that you pay when you buy and/or sell your investment. The loads may be instead of or in addition to the ongoing expenses we just discussed. If the fund only has a load and no ongoing fees, you might do okay if you’re holding your investments long-term—you might even be better off than you would be by paying the ongoing fees. But if a fund has both types of expenses, look out. (Some funds let you cut out the middleman - and the fees, read The Lowdown On No-Load Mutual Funds.)

Comparing To Stocks
Compare these expenses to the commissions for trading stocks and see if you think the difference is worth it. It’s not necessarily a bad thing to pay mutual fund fees—you are, after all, passing the work of picking stocks and managing a portfolio off to a professional. But you should be aware of the effect that even small fees can have on your long-term investment returns and make a conscious choice to incur this expense.

Second, just because a mutual fund is value-oriented doesn’t mean that it is the best-performing mutual fund out there for the level of risk you’re willing to take on. You might get the same or better returns by investing in, say, a balanced fund that tracks both the S&P 500 and a bond index. Also, mutual funds that call themselves value funds might be invested in a lot more than just value stocks, so you might not be getting exactly what you bargained for. Furthermore, over diversification is not a value investing principle, and some value funds may hold many more than the 10 to 50 stocks recommended by successful value investors. (Learn more in Top 4 Signs Of Over-Diversification.)

Third, value investing via mutual funds does not totally eliminate the legwork of choosing investments. Instead of researching individual stocks, you’ll have to research mutual funds. You’ll want to look at the fees, of course, and see how the fund’s investment philosophy compares to your objectives. You’ll also have to be alert for changes—for example, fund managers come and go, and if the new fund manager has a different philosophy than the old one, you may no longer be holding the investment you think you are.

Value investing mutual funds may not hold their stocks for as long as a typical value investor would, which not only brings into question whether the fund manager is truly a value investor, but also has tax consequences. Look at the fund’s asset turnover percentage to determine how much buying and selling activity is going on within a fund. Mutual funds are required to pay out 90% of
their earnings to investors every year, which can create ongoing tax liabilities that will eat away at your returns.

**Value-Investing ETFs**

*Exchange traded fund* (ETF) screeners make it possible to find exchange-traded funds that meet your criteria for fund objectives, portfolio composition, trading characteristics, performance, volatility, fundamentals and tax considerations. ETFs trade differently than mutual funds and often have lower operating expenses. They are also more tax efficient. Unlike stocks, some ETFs can be purchased commission-free through a brokerage account. Like mutual funds, ETFs can suffer from over diversification (from a value-investor’s perspective) and may not provide the level of returns associated with picking winning individual value stocks.

Buying shares of Berkshire Hathaway, practicing *coattail investing*, buying into value-oriented mutual funds and purchasing shares of value-oriented ETFs are all viable alternatives to picking individual stocks. They aren’t as exciting and generally do not offer the high returns investors can achieve by picking winning companies. On the other hand, they require a smaller time investment and may be less risky. (Learn how to apply this to your investing strategy, read *ETFs For A Low-Cost, Long-Term Portfolio*.)

In case you’re not sold on value investing, in the next section we’ll discuss some common alternative investment styles, such as growth investing and investing in index funds.

**Value Investing: Common Alternatives To Value Investing**

There are dramatic differences in the ways different types of investors make their investment decisions. In this section, we’ll look at some of the most common investment philosophies and see how each one compares to value investing.

**Growth Investing**

Unlike value investors, *growth investors* are not concerned with a stock’s current price nor with how that price relates to the stock’s intrinsic value. It doesn’t matter as much to them if a stock is a bit overvalued, as long as its price is rising and is expected to keep going up. While growth investors and value investors both expect to profit from appreciation in stock price, growth investors want to see a 5-year projected growth rate of 10% to 15% per year and want an investment which has the potential to double in about 5 years, which is fairly quickly. Value investors have a longer time horizon—they may hold stocks for decades—and
they are not worried if the stock’s price drops in the short run or about the speed or percentage rate at which the company is growing.

Like value investors, growth investors care about the underlying company’s profit margins. If the company is experiencing earnings growth but expenses are also growing, then profits are not growing and the company may not meet growth investors’ goals. Both value and growth investors also compare a stock’s data to industry averages to get a sense of how the stock is performing comparatively and where the stock’s price might be headed. Finally, growth investors and value investors both strive to achieve returns that exceed industry and market averages, and a growth stock can actually be a value stock if it is priced appropriately and has sound fundamentals. (Learn about other styles of investing in Build A Model Portfolio With Style Investing.)

**Income Investing**

Like value investors, income investors are concerned with safety and principal preservation. However, income investors may look beyond stocks when seeking income-producing investments. Income investors may also consider investment-grade bonds, annuities and perhaps rental properties or real estate investment trusts (REITs). Some value investors also see real estate as a value investment, but in general, value investing is focused on stocks.

Income investors and value investors both want to own the stocks of established, profitable companies; however, income investors make sure to acquire stocks that have a history of sharing their earnings with investors in the form of dividends. Value investors are not concerned with the cash flow an investment generates; they seek to make their money from stock price appreciation. Income investors can make money just by holding stocks—they don’t have to sell to make a profit.

Income and value investors are both concerned with a stock’s fundamentals. Income investors must be careful to choose stocks with strong fundamentals because if the company starts losing money or goes out of business, not only will there no money to pay dividends, but investors will also lose their principal.

If their holdings are not in a tax advantaged account, income investors can experience greater losses from taxes than value investors do because income is taxed at a higher rate than long-term capital gains. That being said, value investors often own income-generating stocks: just look at the holdings of Berkshire Hathaway. (Don’t get forced into action. Learn how to plan properly to avoid making rash decisions, check out Reinvesting Capital Gains In Leveraged Portfolios.)
Technical Analysis

Of the four types of investing profiled in this section, technical analysis is perhaps the most different from value investing. Technical analysts completely ignore the value of the companies whose stocks they purchase and only look at the movement of stock prices. Technical analysts are not interested in a company’s financial statements and don’t perform any fundamental analysis when making investment decisions. Instead, they base their trading decisions on patterns in stock price and trading volume based on historical data. Technical analysts assume that there are trends in the way stock prices behave, and that they can spot those trends and profit from them by timing their trades correctly. Technical analysis is a short-term, active trading strategy, not a long-term, buy-and-hold strategy like value investing.

TUTORIAL: Technical Analysis

The only thing that technical analysts and value investors have in common is that they both believe it is possible to achieve returns that beat market and industry averages. However, some traders who are neither pure value investors nor pure technical analysts believe that the two methods can be used together to determine the most profitable times to enter and exit trades.

Index Funds

An index fund is a type of mutual fund whose investment strategy is to mimic the performance of a particular index, such as the S&P 500 or the Russell 2000. Index fund investors believe in the efficient market hypothesis, which says that stocks are always correctly priced and it is not possible to beat the market, while value investors believe that stocks can be over- or underpriced and that it is possible to beat the market.

Value investing is a somewhat active strategy because it involves researching and selecting individual stocks and monitoring their performance, but it is also a somewhat passive strategy because it has a long investment horizon and infrequent trading activity. Index fund investing is considered a passive strategy because index funds are created by purchasing all the stocks in a particular index rather than by having a mutual fund manager choose specific stocks to invest in. However, a smart index fund investor will still be active in choosing which index funds to invest in. Different indexes have different risk and return profiles, and it is important to track down funds with low expense ratios that won’t drag down returns. (Read more in our Index Investing Tutorial.)
Index fund investors do not choose the companies they own and may not even know which companies they are invested in (who can name all the companies in the S&P 500, let alone a larger index like the Russell 2000?). They certainly aren’t concerned with the fundamentals of individual companies—they couldn’t be even if they wanted to, because there are more individual companies in an index than anyone could reasonably keep track of. Index fund investors are very broadly diversified and generally own stocks of hundreds of companies. Value investors are likely to own the stocks of perhaps 10 to 50 companies—a number that they can reasonably keep tabs on, since they consider themselves investors in the actual companies represented by the stocks, not just speculators in the stock market. Also, since index fund investors aren’t choosing specific stocks, they don’t need to know anything about corporate finance.

Perhaps the only thing that index fund investing and value investing have in common is that both are considered by their proponents to be long-term, conservative strategies. However, a value investor might tell you that investing in index funds is a risky strategy because it won’t generate high enough returns, while an index fund investor might tell you that value investing is a risky strategy because it requires investors to correctly pick just a few winning stocks. That being said, Buffett advocates that the average person invest in index funds. (read about the Greatest Investors of our time

**Value Investing: Conclusion**

Value investing is like buying Easter candy the day after Easter. The candy still has the same intrinsic value—it’s still sugary, delicious and essentially as fresh as it was in the days leading up to Easter. But instead of paying full price to buy the candy the Saturday before Easter, when its demand is highest, value investors buy Easter candy the Monday after the holiday, when demand and prices plummet. They recognize that just because a piece of chocolate is shaped like a bunny doesn’t make it any less delicious.

Value investors get significant discounts on their purchases by questioning the wisdom of market prices. These significant discounts allow them to not only build in a margin of safety that limits their losses in case their purchases don’t work out, but to earn high percentage returns by holding onto their investments until they rise to meet or exceed their true value. Just as they aren’t willing to settle for paying market prices, value investors aren’t willing to settle for average returns. They believe that if they are willing to do the legwork, they can beat the market. (For related reading, see Finding Profit In Troubled Stocks.)
If you’re already a bargain shopper, an independent thinker, a diligent worker and a patient person, you probably have what it takes to become a successful value investor. Value investors commonly do their own research and fundamental analysis, relying on financial statements and metrics such as profit margins, price-to-earnings ratios and book value to pick individual stocks to invest in. If this method doesn’t appeal to you, however, you can pursue value investing through other means or try a different investment strategy altogether.