Mister Valuation plans for 2018: A New Year a New and Better Approach

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The Principles of Valuation: A Year-Long Series Elaborating On Sound Value Investing Principles

Introduction

Every year I take the holidays off in order to reflect on what I have accomplished for the year, but more importantly, to think deeply about and contemplate what I might do better in the upcoming New Year. This process has provided me with numerous inspirations over the years, and this particular year was no exception.

As 2017 came to an end, I found myself exceptionally frustrated (perhaps, as I am getting older my patience is wearing thinner). My frustrations were born by reading and/or listening to the articles, reports and comments of many people lamenting short-term underperformance (a stock they just bought falls a couple points) or smugly expressing confidence about the laurels of certain stocks they own even when they are massively overvalued by the market today.

This frustrates me because from where I sit, investors that think and behave this way lack the ability to see and deal with risk or opportunity when it is evident based on fundamentals. Consequently, investors that behave this way are most likely to sell when they should buy, and buy when they should sell. Accordingly, I was inspired to try and do everything that I could by sharing all that I have learned over all the years I've been in the investing industry. My simple objective is to try and help people invest more successfully. Ergo, I decided to do a year-long series presenting fairly valued common stocks of all types, and simultaneously provide teachable real-world lessons on the sound and proven principles of value investing.

This is important to me because when my career began more than four decades ago, I pledged to do everything in my power to **bring sound fundamental investing principles and practices back to the forefront of investors' minds where they belong.** Long-term value investing works superbly because it is based on financial realities and factual financial data. In contrast, short-term speculation (guessing where the price of a stock might go in the short run) relegates your financial security to a mere game of chance, and thus becomes more a game of luck than skill. I don't want to be lucky with my investments; I want to be smart and prudent with them.

To my young mind this seemed achievable because it seemed clear that the principles of business, economics and accounting were timeless, sound and proven to work in real-world situations. Therefore, the truth would prevail if investors were properly and clearly presented with the irrefutable evidence that the examination of sound fundamental investing principles provide. Not to mention that these principles of value investing are supported, promoted and practiced by virtually every renowned investor that has ever lived. Investing greats such as Warren Buffett, Philip Fisher, Peter Lynch, Marty Whitman, and so many others too numerous to mention, all embrace long-term value investing.

Note: as I will discuss further in the conclusion of this article, my series of articles for 2018 will be written to present what appear to be attractively valued research candidates that also reflect a timeless value investing principle. Therefore, my secondary objective for 2018 articles will be to provide prescreened and apparently attractively valued research candidates available for different investment objectives. I decided to do this because one of the biggest complaints I am hearing from investors today is that it's hard to find attractively valued investments in this overheated market. Keep in mind that in every market – whether it is a bull market or a bear market – there will be attractively valued stocks to be found.

Therefore, my goal is to screen and provide attractively valued common stock investments that investors can research deeper on their own. Importantly, many of these candidates will be presented prior to my conducting a comprehensive research and due diligence process. As a result, I will be able to provide loyal readers with many more opportunities than I could if I waited to write the article after I spent the time and effort to conduct extensive research.

With that said, my primary objective for 2018 is to (as I previously stated)**bring sound fundamental investing principles and practices back to the forefront of investors' minds where they belong.** Therefore, each fairly or attractively valued research candidate that I present will also provide me the ability and opportunity to illustrate **a single principle of value investing** under real-world or actual conditions. In the past, my work often covered numerous investing principles within one article. My hope is that by focusing on a single value investing principle I can greatly simplify the learning process. Also through providing a real-life example of that principle in action, I hope to empower readers to more effectively learn, embrace and understand each and its importance.

Alas It Seems You Can't Change Human Behavior

Sadly, even after all these years, and the thousands of articles I've written on the subject and including my discussions with many thousands of investors of all levels over the years, I have sadly come to the conclusion that I have failed to move the needle even a little bit. People simply cannot help themselves from reacting to short-term price volatility. Consequently, I failed to properly gauge the incredible power and force of basic human nature. On the one hand, people are intelligent, and as such, fully capable of analyzing, understanding and evaluating basic investing principles. Consequently, they are innately capable of making and recognizing intelligent investing decisions.

On the other hand, people are also emotional beings with strong egos. As a result, when they are placed into a heightened emotional state, logic and reason can be lost in favor of reacting emotionally. In psychological circles, this basic characteristic of human nature is referred to as "the fight or flight response."

Unfortunately, for those investors that cannot control their emotions, short-term drops in stock prices all too often elicits the flight response. Regardless of whether the price drop is fundamentally justified or not, an acute stress response is triggered, the stock is sold and unnecessary (temporary) losses are then made permanent. Since nobody has ever been able to truly forecast short-term price movements this human need for instant gratification is very bad for your long-term financial health. Excessive activity overexposes you to mistakes and taxes and trading costs erodes your total returns.

True value investing is comprised of controlling risk coupled with a realistic time horizon. It takes time for a business to generate an increase in its true worth. The source of future value creation will be directly proportionate and related to the amount of future earnings and/or cash flow growth the business can generate. It's critical to accept and realize that the business' future value generated by its growth of future earnings and/or cash flows is independent on the value of the business today. In other words, the future value will be created by the company's growth as it manifests in the future regardless of what you pay to buy it today. If you overpay for the stock today, your future returns will be less than had you originally purchased it at a sound or attractive valuation.

But most importantly, it takes time for a business to grow its revenues and sales – which ultimately translates into future levels of earnings, cash flows and dividends. Financial results are not reported every minute of every business day like stock prices are. Companies typically report their financial statements quarterly, and these quarterly reports are the only time that real information becomes available. For the most part, the information that comes between the quarterly reports is simply noise at worst – or opinion at best. Therefore, the primary distinction between a true value investor and a speculator trader is the willingness to commit and recognize the proper time horizon for which to judge success or failure.

We can utilize the Rule of 72 to put this principle into its proper perspective. For example, it takes a business 14.4 years to double its earnings and cash flows (and therefore its value) at 5% growth. At 10% growth it only takes 7.2 years to double its earnings and cash flows, and at 20% growth in only takes 3.6 years to double its earnings and cash flows. Nevertheless, even at very high returns (20%) it still takes several years for real value to be created as a result of the company's growth. Therefore, it seems senseless to stress over short-term price actions. Wait for at least a full business cycle before you judge the success or failure of your investment decisions. Remember, it takes time for the business and your investment in it to grow.

Nonetheless, the critical point is that it takes the passage of time (years – not days, weeks or months) for increases in true worth value to manifest. Therefore, attempting to judge the success or failure of your investment decisions over any timeframe less than a full business cycle (3 to 5 years typically) is an exercise in futility. True investors simply must accept the reality that daily price actions are emotionally driven and often not truly reflective of the intrinsic value of the company in the short run. Therefore, wise and clear thinking value investors exploit irrational price volatility (they buy or sell depending) and never react to it.

The father of value investing Ben Graham wrote in*The Intelligent Investor*:

"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory [or 'adequate'] return. Operations not meeting these requirements are speculative."

For additional clarity, an easy way to differentiate between investing and speculating is to look at the amount of risk involved and the time horizon. Speculation is generally high-risk and short-term focused. On the other hand, investing is typically considered lower-risk and longer-term focused. This speaks loudly to the old Wall Street adage: “time in the market over market timing.” The venerable father of value investing Ben Graham eloquently offered this additional distinction between investing and speculating in his seminal investing book “The Intelligent Investor” as follows:

“The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator’s primary interest lies in anticipating and profiting from market fluctuations. The investor’s primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are important to him in a practical sense, because they alternately create low price levels, at which he would be wise to buy, and high price levels, at which he certainly should refrain from buying and probably would be wise to sell.”

Summary and Conclusions

I truly believe that most of the people I’ve personally counseled over my financial career are smart enough to be successful investors. However, my personal experience also tells me that most investors have a great deal of difficulty keeping their emotions in check when handling their investment portfolios. Few things in life are more sacred to people and their families than the health of their finances. Therefore, it’s easy to understand how they can become so emotional, especially during turbulent times in the markets.

Nevertheless, the venerable super investor Warren Buffett summarized the importance of keeping our emotions in check via the following quote:

“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.”

But, as I stated earlier, I do not believe there is any place for emotional responses when dealing with our investments. In order to successfully manage our investment portfolios, we need to be analytical and critical with our examinations and evaluations. In short, the numbers must always add up, and there is no benefit to rationalizing about nonsense such as this-stock-deserves-a-higher-valuation than other comparable companies. The numbers either says it does, or the numbers say it doesn’t – it’s as simple as that, so do the math.

So, here is what I have decided to do in order to more efficiently and effectively help as many investors as I could during 2018 and beyond. Each article I write in 2018 will be based on a specific value investment principle that I feel strongly about sharing with my loyal readers. To keep things focused and simple, I will provide a fast-moving FAST Graphs “analyze out loud video” covering a single company (on occasion I may cover more than one company) that represents a quintessential example of a company that reflects this principle in its real life history and is simultaneously fairly valued or undervalued.

They say that a picture’s worth 1000 words, but if true, then how many words is a video worth? I don’t have an exact answer, but I assure you that a well-produced video analyzing a company’s fundamental strengths and weaknesses is worth many many more. With the video format and the utilization of FAST Graphs – the fundamentals analyzer software tool – I know that I can provide a more comprehensive fundamental evaluation than I could with a long article comprised of thousands of words.

In summary, in 2018 I intend to constantly screen for and provide as many attractively valued stocks of all categories in this extended bull market as I can. By moving to this format and approach, I can be significantly more prolific with providing attractively valued research candidates. But more importantly, I can focus on a single value investing principle thereby enhancing the readers’ knowledge and hopefully their investment opportunities and financial success.

Sidebar: My first installment will actually cover the three most prominent pharmacies in America: CVS Walgreens (WBA) and Rite Aid Corporation (RAD) – it should be posted shortly. The underlying investment principle will be as follows: Price volatility is Not Risk Because Not all Price Drops are Equal! The following short video clip covering CVS only provides a sample of the 2018 articles and the “analyze out loud” videos:

CVS Health Corporation (CVS) not all price drops are equal!

Disclosure: Long CVS

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