

The Death of Value?

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Equity investors can be put into two distinct types: those that try to unearth future potential that others do not yet recognise (growth investors) and those that believe the market is undervaluing a company based on its intrinsic worth (value investors).

Over the past decade many traditional value investors have struggled as the evolving economic environment has made investors question their assessment of future 'intrinsic value' whilst interest rates remain near zero. To put it simply with an example, how can a company in a traditional economic sector such as Banking maintain and grow its shareholder value whilst making no money on deposits and facing increased regulatory burdens following the 2008 crisis?

One principle of value investing has always been reversion to the mean. If you buy something for less than its worth, eventually the market will notice and push the price up – this is mean reversion. 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, the physical assets it owned. Intangible assets (non-physical assets such as brand, goodwill) now account for over 80% of the average company's market value in the USA. We will focus on this market because many of the companies with difficult to value intangibles are American.

Companies have 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 their tangible 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 tangible book values to mean revert is flawed 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 and investors must not confuse this with the death of value investing itself. Mean reversion needs to be understood in the context of changes in the economy, such as the greater 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 cannot 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. Tacit portfolios have a large exposure to

these types of 'value' companies through holdings such as Finsbury Growth & Income Trust and Loomis Sayles US Equity Leaders fund.

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