

Shades of Value

Simply defined, value investing is the strategy of buying stocks for less than what they are worth. However, the determination of a company's true worth or 'intrinsic value' is based on a variety of variables and is considered highly subjective. With so many ways to skin a cat, it's no surprise that several variations of value have surfaced over the years.

Nonetheless, most would agree that Benjamin Graham started it all when he and his colleague David Dodd published Security Analysis in 1934. In a nutshell, Graham favored stocks with low price-to-earnings and price-to-book ratios. He believed that buying and holding a diversified portfolio of cheap stocks would yield high returns.

Deep Value

Graham's philosophy evolved into what is now known as deep value investing. This intrepid strategy often toils in the most unloved areas of the market. That's because deep value investors tend to be contrarian in nature, believing that opportunity is borne out of pessimism. They ultimately want to buy companies whose earnings are depressed and whose stocks are trading at rock bottom multiples; if the firm recovers, both its earnings and stock price should

pop. However, long stretches of underperformance can make it tough for investors to stay the course with this approach.

Relative Value

In relative valuation, the focus is on identifying stocks that are cheap relative to their historical multiples, industry peers, or the overall market. Typically, investors focus on conventional valuation ratios like price-to-earnings, price-to-sales, or price-to-cash flow. This strategy is objective, easy-to-use, and less rigid than other approaches. In fact, relative value necessitates fewer inputs than an absolute valuation strategy.

This strategy is not without risks. Stocks may be relatively inexpensive for good reason. They could be facing financial difficulties, growing pains, legal troubles, or other adverse developments. However, an astute investor should be able to

separate the good from the bad.

It is also entirely possible that a stock appears cheap on a relative basis, but is quite expensive from an absolute standpoint. For example, at the peak of the technology bubble, an investor might have bought tech stocks that looked cheap compared to their industry peers, only to discover, when the bubble burst, the entire sector was overvalued.

Variations on a theme

Perhaps the most famous disciple of Graham's teachings is Warren Buffett. While a staunch follower of Graham in his early years, the Oracle of Omaha ultimately forged his own path. Buffett prefers to buy attractive businesses at fair prices rather than fair businesses at attractive prices. While valuation is a key consideration, he's looking for companies that are built to last. ■

Despite the differences in style, value investors share the view that when they buy a stock, they are purchasing a piece of a business. Another commonality is that value investors shy away from making broad market and sector calls – it's just not worth trying to time the market.