

Value Investing

FOR

DUMMIES®

2ND EDITION

by Peter J. Sander and Janet Haley



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Dedication

I dedicate this book to do-it-yourselfers and especially do-it-yourself investors everywhere, and to those who recognize the value of knowing what questions to ask even if they don't do it all themselves. And, it would be impossible to do a project like this without recognizing the master himself, Warren Buffett, who has so clearly demonstrated that successful investing is a matter of wisdom, not just information or knowledge, and most certainly not guesswork.

— Peter Sander

Authors' Acknowledgments

Many individuals and life experiences have taught me to recognize not just the cost or benefit but the value of something I might choose, be it a purchase, a place to live, or an investment. I'd especially like to thank my parents, Betty and Jerry Sander, for instilling this perspective from an early age. And no book can happen without the professional guidance and assistance of an editorial team, and I'd like to recognize and thank Stacy Kennedy for her overall supervision of this project and Tracy Brown Collins for her adroit editorial guidance throughout.

— Peter Sander

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Introduction

Markets go up; markets go down. It doesn't matter whether you measure it statistically or look at a chart. You can see it easily. We've seen more volatility during the past 10 years than ever before. And our hearts jump into our throats every time we hear about one of those 200-point sell-offs. Right?

You lived through the Asian market crisis of the late 1990s. You lived through the post-2000 dot-com bust. Heck, if you're old enough, you lived through the famous October 19, 1987 "Black Monday" debacle. It's all part of investing. Right?

Sure, like most other investors, you probably lost some money during these events — on paper, anyway. Sour markets have a way of putting a damper on everything. But do all stock prices drop? Especially in the long term? Hardly. Average stock investing performance, over the long haul, achieves roughly an 11 percent return per year.

Some investments do a lot better than that. And some will even take you through the down cycles with little to no heartache.

And what investments are those? They are investments in truly good *businesses* with enduring and growing value. Starbucks isn't just about coffee; it continues to change the market for an informal business and pleasure "hang-out" and is now shifting focus to overseas expansion. Procter & Gamble continues to dominate the grocery shelf. A lesser known used car retailer called CarMax threatens, with an excellent brand and business model, to dominate the used car space, though today its market share is less than 2 percent.

Bottom line: The best businesses that have the best brands, best assets, best business models, best management teams, and best business strategies continue to earn, earn, and earn some more. And if you, as an investor, (1) recognize the value and (2) buy them cheap, you're setting yourself up for better returns than the market average. And that, as we'll see, is a very, very good thing.

Which leads us to where this book is headed. *Value Investing For Dummies*, second edition, takes you on a journey back to the tried-and-true principles of valuing a stock as one would value a business. (After all, how can one disconnect the two, as a share of stock is a share of a business. Right?) When

the price, or value, of a stock matches the value of a business, the value investor *considers* buying it. When the price of a stock is *less* than the value of the business, the value investor warms and may *get excited* about buying it. It may be a true buying opportunity. And when the price of the stock skyrockets beyond the value of the company, yes, the value investor *sells* it or avoids it altogether.

It's good old-fashioned investing. Believe it or not, markets do undervalue businesses, and do it frequently. For a variety of reasons, markets are far from perfect in valuing companies. And furthermore, because there is no one secret or magic formula for valuing a business, the true value of a stock is a matter of difference of opinion anyway. All of which serves to make investing more fun — and profitable — for the prudent and diligent investor who sorts through available information to best understand a company's value.

A value investor who applies the principles brought forth in this book is essentially betting with the house. The odds, especially in the long term, are in your favor. Value investing is an *approach* to investing, an investing *discipline*, a *thought process*; it is not a specific formula or set of technologies applied to investing. It is art and science. It is patience and discipline. Done right, it increases the odds but doesn't guarantee victory. For you active traders, it's a slower ride. But the value approach lets you share in the growth of the American (and world) economy, while also letting you sleep at night.

How to Use This Book

This book presents the principles and practices of value investing. As with all investing books, you probably shouldn't follow this material to the letter, but rather incorporate it into your own personal investing style. Even if you don't adopt most of the principles and techniques described here, your awareness of them will most likely make you a better investor.

This value investing reference visits tools that all but the most inexperienced investors have heard of: annual reports, income statements, balance sheets, P/E ratios, and the like. *Value Investing For Dummies*, second edition, uses these tools to create a complete, holistic investing approach. You'll learn *why* annual reports and information contained therein are important, and *how to use* that information to improve your investing. And it's hardly just annual reports. Other information sources, both online and offline, can greatly enhance your knowledge of a company's prospects and your proficiency as a value investor.

What Is Assumed About You

Value Investing For Dummies, second edition, assumes some level of familiarity and experience with investments and investing. The book assumes you understand what stocks are and how markets work, and have already bought and sold some stocks. If you're starting completely from scratch, you may want to refer to Eric Tyson's *Investing For Dummies* or a similar introductory treatment of the investing world. Not that what's presented here is that "hard" or scary, it will just flow more smoothly with a base level of knowledge.

How This Book Is Organized

Like all *For Dummies* books, this book is a reference, not a tutorial, which means that the topics covered are organized in self-contained chapters. So you don't have to read the book from cover to cover if you don't want to. Just pick out the topics that interest you from the Table of Contents or Index and go from there. What follows is a breakdown of what the book covers.

Part I: The What and Why of Value Investing

Part I explains what value investing is (and what it isn't) to give a clear picture to the reader and provide a framework for the rest of the book. Value investing is put in context with a discussion of markets, market history, and overall performance. We explore the history of the value investing approach and the fantastic success of some who practice it, notably the master himself, Warren Buffett.

Part II: Fundamentals for Fundamentalists

Part II opens the value investor toolbox by explaining some basic investing math principles and how understanding that math can make you a better investor. Next is a discussion of key information and information sources for the value investor. Then comes the detail, with a tour of the financial statement landscape, including balance sheets, income, and cash flow statements. Ratios and ratio analysis are explored as a way to make more sense of the financials. Finally, you'll get a few tips on how to detect hidden agendas that may lie in financial figures and statements.

Part III: So You Wanna Buy a Business?

Out of the frying pan and into the fire. Next come the “meat and potatoes” of how to assess or appraise the value of a company and relate that value to the stock price. Proven business value assessment methods including intrinsic value, discounted cash flow analysis, and the strategic profit formula are examined. Next, on the principle that investors shouldn’t live by numbers alone, is a discussion of strategic intangibles — so-called “soft” factors that serve as leading indicators for the “hard” numbers. To bring these tools and techniques together into a system, we’ll look at the example set by the master, Warren Buffett. With these principles in mind, the next step is to look at price, to see whether a company really is a good value for the price.

Part IV: Becoming a Value Investor

This part takes a practical look at investment products — mutual funds, closed ended funds, REITs, and exchange traded funds (ETFs) — and how the value investor may use these products. Then, the focus shifts to setting goals and developing your own value investing style. We examine different value investing themes and then suggest practical approaches to implementing the value investing thought process, not only for buying but also during ownership and, eventually, the selling decision. At the end of the day, it’s all about figuring out what works best for you.

Part V: The Part of Tens

For your use and enjoyment you’ll find some favorite top-ten lists in this section: Ten characteristics of a good business and stock value, ten indications of an overvalued business, and ten habits of “highly successful” value investors.

Icons Used in This Book

Throughout the book, bits of text are flagged with little pictures called *icons*. Here’s what they look like and what they mean:



Just as the name suggests: a piece of advice.



The dark side of a tip: advice on what to avoid or watch for.



Deeper explanation of a topic or idea. You can usually skip text flagged with this icon if you want to.



Not a must-read, but fun, relevant facts to enjoy as you drill through this book.



If you forget everything else you read, keep this information in mind.

Part I

The What and Why of Value Investing

The 5th Wave

By Rich Tennant



"It hasn't helped me sell more hot dogs, but I've had several inquiries for investment advice."

In this part . . .

We hope to give a clear picture of what value investing is and isn't and also provide a framework for the rest of the book. We put value investing in context with a discussion of markets, market history, and overall performance, with an emphasis on market nature — key market behaviors and quirks that repeatedly, through history, provide opportunities for the value investor. We explore the history of the value investing approach and the fantastic success of some who practice it, notably the master himself, Warren Buffett.

Chapter 1

An Investor's Guide to Value Investing

In This Chapter

- ▶ Recognizing the value investing style — what it *is* and *isn't*
 - ▶ Bottom-line value investing principles
 - ▶ Comparing value investing to other investing styles
 - ▶ Deciding if you're a value investor
-

No doubt, if you're reading *Value Investing For Dummies*, somewhere during your investing career you heard something about value investing. You heard about it from your retired next-door neighbor. You heard about it as “what Warren Buffett does.” You saw a mutual fund describe itself as a “value-oriented” fund.

You have a pretty good idea what the word “value” means in ordinary English. It's not an altogether precise concept; the *Random House Dictionary of the English Language* defines it as the “relative worth, merit, or importance” of something. Okay, fine. But how does that apply to investing? What *is* value investing, anyway?

This chapter answers that question. The rest of this book gives you the background, tools, and thought processes to do it.

Definitions? No Two Are Alike

Perhaps you've asked around — to friends, experienced investors, investing professionals — for definitions of “value investing.” You probably got a lot of different answers. Those answers perhaps included phrases like “conservative,” “long-term oriented,” “the opposite of growth,” “the Buffett approach,” “buying stocks with a low P/E,” “buying stuff that's cheap,” or “buying stocks that nobody wants.”

None of these is “it” entirely, but it turns out they are all *part* of it.

All, except the “opposite of growth,” that is — and we’ll get to that.

Value investing is an investing approach and style blending many principles of business and financial analysis to arrive at good investing decisions. This, too, is an imprecise definition, but it lays the groundwork for the more precise principles and style points that follow.

What Is Value Investing?

Toward a definition, here’s one you may have read in the first edition of *Value Investing For Dummies*. It still works:

Value investing is buying shares of a business as though you were buying the business itself. Value investors emphasize the intrinsic value of assets and current and future profits, and pay a price equal to or less than that value.

You’ll quickly note key phrases: “buying a business,” “intrinsic value,” and “pay a price equal to or less than that value.” These are explicit tenets of the value investing approach, and underlying them all is the notion of conscious appraisal — that is, the idea of a rigorous and deliberate attempt to measure business value.

You’ll also notice that “price” enters the appraisal, but not until the end. Value investors only go to the stock market to buy their shares of the business. Value investors don’t look at the market as an indicator of whether to invest.

With this definition of value investing as an appetizer, here’s a “main course” of value investing principles.

Buying a business

If you take nothing else away from reading this book, take away the thought process that investing in stocks is *really* (or should be) like buying a business.

That concept shouldn’t really be that hard to grasp — after all, when you buy shares, you *are* buying a *portion* of a business, albeit in most cases a small one. This isn’t to say you have to buy a larger share of the business to think of your investment as buying a business — this principle applies even if you’re buying a single share.

Put differently, whether it’s an espresso cart or 1,000 shares of Starbucks you want to buy, the purchase is analyzed the same way. Treat the investment as