Style over substance

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Telephone calls may be recorded.

"If I make the same mistakes at the same time every day, people will start calling it style."

– John Prine

John Prine may be an American country songwriter – and the quote refers to his guitar playing – but there are surely echoes in the investment world.

At the risk of offending my fellow investors, I've noticed an increasing number of stock pickers explaining their disappointing performance through style or investment factors as though these are outside of their control. In particular, the recent claim is that "value" investment is out of fashion and therefore the performance of the value investor can be excused – it's not their fault that the investment background is out of kilter with their chosen style. I think this argument does not hold and can be exposed from a number of different angles.

What is value investing?

A firm definition is elusive, and its practice has definitely changed over time.

It's obviously important to distinguish between price and value; as Warren Buffett has said "Price is what you pay, value is what you get". We believe taking the time to properly analyse the value of any investment before purchase is the best course of action. The price paid for an investment is one of the very few component parts

Key risks

The value of your investment is dependent on the supply and demand for the shares of the Investment Trust rather than its underlying assets. The value of your investment will not be the same as the value of the Investment Trust's underlying assets.

Capital is at risk.

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an investor can influence and it's clearly an important part of the equation that determines subsequent performance.

Value must be about a total assessment of a company's worth and into that calculation all aspects of the business should be considered. When we make our assessment of a company's valuation we try to cover as many facets as possible, but mostly our valuations are driven by forecasts of a company's cashflow; into that estimation, growth and stability of returns are vitally important factors. To characterise value investing as something as simple as buying stocks with a low multiple, whether that be book value, earnings, cash flow, sales or something else, is surely a gross over-simplification.

I think we all recognise these strong "value" criteria, but there are as many combinations of these as there are stocks so inevitably any definition of "value" investing becomes subjective.

Not only is it impossible to pin down a firm definition, the concept of value investing has morphed dramatically over time. Benjamin Graham, widely acknowledged as the 'father of value investing', and Warren Buffett's mentor, set out a short list of requirements for inclusion in his portfolio. Of those seven, only two (and incidentally the last two on the list) are directly related to price:

1. Price of stock no more than 1½ times net asset value
2. Price no more than 15 times average earnings of the past three years

The other five (all seven are listed at the end of this piece) would in no way be captured by the blunt description of value stocks most investors would cite.

It is also fair to say that market conditions are very different today to when Graham was most active. Markets are possibly more efficient now and arguably are higher priced, but the safe yields against which Graham was evaluating stock opportunities have changed out of all recognition, as the UK government long bond yield is currently around 1%, vastly lower than anything experienced in Graham's lifetime. Given the massive change in the investment landscape, it seems likely that some of the detail of Graham's value requirements might change, even if the broad concepts should be constant.

To be clear, I would say we are value investors, but in the Graham sense that we value companies as ongoing businesses, we put real value on growth and stability of strong returns and look for companies with strong finances. We would never find a company attractive just because it was trading at a low multiple of something or other.

It's stock pickers who blame style

The investors feeling they are out of sync with the market nearly always claim to be stock pickers. It certainly appears to be how their portfolios are constructed and their reports show the portfolio stock by stock but don't generally comment on factor and style exposures. Really, it is the performance of individual stocks that drives investment performance; performance is ultimately about stock picking.

A simple topical example should illustrate this – Thomas Cook would undoubtedly have been viewed as a "value" stock – the shares traded at a very low multiple of profits and it had substantial turnover relative to its market capitalisation. It certainly had some well-known value-biased investors as shareholders. Can the catastrophic performance of the company's shares be blamed on a bad patch for value investing? Absolutely not – it was a highly leveraged company, in a competitive sector, facing traditional rivals and internet competition, with a high degree of cyclicality and seasonality. Its failure will have had a negative impact on value indices, but no investors were forced to own it, so to hide behind an amorphous investment factor would just be wrong. In this case, the dent to performance comes not from style, but stock selection.

The recent crop of profit warnings shows us that the current environment is pretty unforgiving. But for all the negative media headlines, we should remember that in the UK, employment is at record highs and interest rates at extraordinarily low levels. If companies are struggling in this environment, and many of these might crudely fall into the 'value' category, I fear it says more about the strength of their businesses than anything else.

Use mistakes to learn, not to blame

Returning to the blame game, there's another adage that can help in the thought process: "Invert, always invert". This quote, originally from the German mathematician Carl Jacobi, has been more recently popularised by Warren Buffett's partner, Charlie Munger. It asks us to think about any statement the other way around to find solutions or to check for consistency. In this case, have these investors ever passed on credit for good performance to the value factor? I think not. "Please, it's not me, it's just my investment style that has come good." If an investor isn't ever going to admit that then they shouldn't look to blame poor performance on the same thing.

Over the 22 years I've been managing BMO Capital and Income Investment Trust, I'll openly admit mistakes, both in shares I've bought, and shares I should have bought, but I believe that I have learnt from these mistakes as stock picking errors, errors of strategic assessment and errors of portfolio construction. The evolution and improvement of our investment process, I believe, bears testimony to that.

None of us have perfect foresight, the world is a difficult and unpredictable place, but it seems the best way to make progress is to change what is going wrong and keep what is going well. We aim to learn not just from our own mistakes, but those of others as well.

From Benjamin Graham's The Intelligent Investor Ch13 Seven Statistical Requirements for inclusion in a defensive investor's portfolio:

1. Adequate size
2. A sufficiently strong financial condition
3. Continued dividends for at least the past 20 years
4. No earnings deficit in the past 10 years
5. Ten-year growth of at least one-third in per-share earnings
6. Price of stock no more than 1½ times net asset value
7. Price no more than 15 times average earnings of the past three years

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