

## ALIGNING VALUE INVESTING WITH TODAY'S BUSINESSES

*"The fact is that the annual change in Berkshire's book value ... is a metric that has lost the relevance it once had."*

- Warren Buffett, 2018 letter to  
Berkshire Hathaway shareholders

With one of our era's most successful value investors telling his shareholders that his once primary metric for tracking value is no longer meaningful, the time has come to revisit how changes in business mix, growth strategies and accounting conventions can impact the metrics often used to define value. Overall, standard definitions that investors have traditionally used as shortcuts for identifying value may be losing some of their efficacy.

### ASSESSING THE RIGHT METRICS FOR IDENTIFYING VALUE

Today, it is increasingly important to use a more nuanced and comprehensive definition of value that goes beyond traditionally used measures.

Simple value metrics have become less reliable as the market has grown more efficient and the mix of business models and accounting conventions have shifted. While many of the issues in relying

on these simple measures have always existed, the influence of these metrics on market aggregates has increased. Historically, investors had a reasonably good starting point for finding value by categorizing companies using price to book (P/B) or price to earnings (P/E) ratios. Now, investors must be prepared to make adjustments more frequently and to consider multiple factors in their search for value. The signals from traditional metrics might not be as clear given the growing importance of intellectual property and other intangible assets, new practices for applying accounting conventions, and widespread use of stock buybacks.

Intrinsic value, which is a function of future free cash flows (FCFs) discounted to the present, is what ultimately matters to investors. However, estimating intrinsic value is difficult due to the number of assumptions needed. Calculating intrinsic value requires clear expectations for the normalized margins of a company. Also

investors must have an outlook for future revenue growth. This type of analysis requires forecasting significant changes in the steady state of a business. For example, investors must model the impact of potential new markets or gains in share.

As a result, value investing often relies more on traditional accounting metrics than forecasts in order to create shortcuts to gauge relative value. Influenced by Fama and French, and further entrenched in the methodologies through which indices are constructed, value has typically been measured in terms of P/B or P/E.

The specific measures used to assess statistical discount matter. As Exhibit 1 shows, there can be dispersion in the performance of different signals. For example, FCF measures have held up better than those based on book value or earnings. Cash flow measures have shown better reliability especially in recent periods during which most traditional value factors have been less effective.

**EXHIBIT 1: Excess Returns of Lowest Valuation Quintile (Russell 1000 Index)**

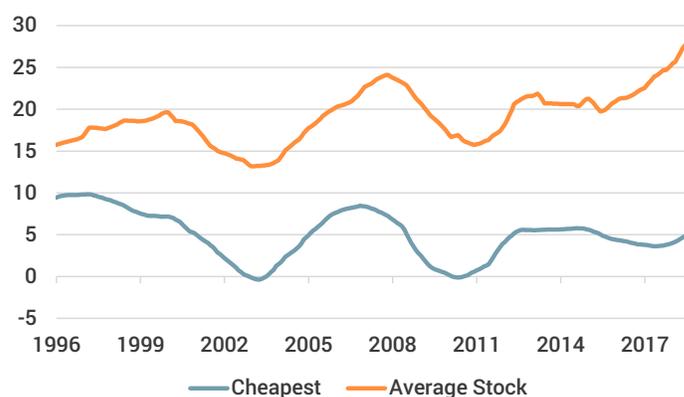
	Past 5 Years	20 Years Prior
Price/Book	-2.0	2.5
Price/Earnings	-1.5	3.3
FCF Yield	0.9	4.4

Sources: Compustat, Russell, FactSet  
Data as of March 31, 2019  
Past performance is not indicative of future results.

Further data from our analysis raises questions about whether traditional shortcut measures are losing some of their efficacy. Exhibit 2 shows this may be happening to P/B as well. As the graph

illustrates, the average company has seen its return on equity nearly double during the period. Companies that would screen as having the least expensive P/B valuations have seen their return on equity decline. With that backdrop, investors should expect the lowest P/B stocks to trade at a discount to the average stock. But, without fully considering the overall trends in return on equity, investors might assume that any larger discount today is a valuation opportunity that should revert to its historical level.

**EXHIBIT 2: Return on Equity by Price/Book (rolling 3 years)**



Sources: Compustat, Russell, FactSet  
Data as of March 31, 2019  
Past performance is not indicative of future results.

## FOUR AREAS TO CONSIDER WHEN SELECTING VALUATION MEASURES

Today's more complex valuation environment is largely due to different strategies to drive growth and the resulting accounting choices. As investors are selecting the right valuation measures or combination of inputs for their investing strategy, they must be sure to consider these four elements:

### 1 | GROWTH INVESTMENTS

Business conventions have changed. Today, companies are investing more in research and

development (R&D) and branding than in property, plant and equipment (PP&E). The former is expensed and not reflected in book value. The latter is capitalized and amortized.

For example, a business choosing to grow through capital expense investing may have a modest P/B and P/E, but a high P/FCF. Historically, this scenario has been common because most business investment was primarily through capital expenses. This creates real assets that show up on the balance sheet and are depreciated over time through the income statement.

Alternatively, a growing trend has been more business investment in R&D, which can often result in a very high P/B and P/E, but a more moderate P/FCF. This approach generally creates intangible assets that are not reflected on the company's balance sheet and whose costs are recognized as incurred.

A basic example shown in Exhibit 3 illustrates the impact of the differences in approach. Two companies start with \$100 in cash and investments funded entirely with equity. That investment earns a 10 percent return, which is paid out to its owners.

Each company has an opportunity to invest half of its current assets into a venture that will eventually earn 15 percent but will not generate any return initially.

Company A's opportunity is to build a manufacturing facility, so it uses \$50 that shows up on its cash flow

statement as a capital expense and creates a \$50 asset in PP&E. In this instance, its equity account and earnings are not impacted by this expense.

Company B's opportunity is to engage in research that will develop a patent on a product that another company will manufacture for it. Company B's \$50 is expensed on its income statement, which lowers its earnings and equity account. Company B's cash flows look the same as Company A since it also spent \$50 and still made \$5 from its remaining original investment.

EXHIBIT 3: Two Growth Investment Scenarios

	Year 0	Year 1	
	Both Companies	Company A	Company B
Opportunity		Build a manufacturing facility	Engage in research that will result in a patent on a product that another company will manufacture for it
Approach		Cap Ex	R&D
Cash/Investments	\$100	\$50	\$50
PPE	\$0	\$50	\$0
Equity	\$100	\$100	\$50
Income	\$10	\$5	(\$45)
Free Cash Flow	\$10	(\$45)	(\$45)

Since the return on each investment will be the same, the value of each company should also be the same. But, that value described as a multiple of each company's book value and earnings will be quite different because of the way each has invested for growth.

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Company B will be a high P/E and P/B stock relative to Company A. Yet, this tells an investor very little about whether one is undervalued versus the other.

## 2 | ACCOUNTING CONVENTIONS

In addition to accounting differences that can arise from different types of investment, both book value and earnings can be manipulated and shaped by other subjective judgments on the part of management. Forensic style due diligence is required to ensure that value is not illusory.

## 3 | MERGERS AND ACQUISITIONS

M&A further complicates comparisons since in an acquisition, all assets—tangible and intangible—are added to the balance sheet. This means that two companies with the same business model can have very different accounting ratios, depending on whether the business was created through internal development or via an acquisition.

## 4 | RETURN OF CAPITAL

A company's decision about how to deploy its excess capital can also significantly influence valuation measures. Returning capital to shareholders via dividends or share repurchases instead of reinvesting in its business will reduce stated book value. When a business has an intrinsic value above stated book value and chooses to return capital to shareholders, the company will drive book and intrinsic value further apart, as Buffett alluded to in his letter. That scenario combined with some of the other issues mentioned can cause investors to see companies with very low, or even negative, stated book value.

These items should be key considerations in the valuation approach for today's companies. At the same time, measures that investors have typically used can still have a complementary role in helping to simply contextualize whether a stock, or group of stocks, may be at an attractive investment level. Most benchmark indices and ETFs that track them rely heavily on those more traditional metrics to define value. Many index creators recognize the weakness of relying on a single factor and instead use a basket of measures. But, investors who pay attention to the issues noted above may be able to improve on their ability to identify relative value—if they select the most appropriate metrics and comparative basket of stocks.

## COMBINING OLD AND NEW FOR EFFECTIVE VALUATION

Warren Buffett's question about the relevance of such a widely used measure as book value is a reminder for investors to take a critical look at the methods they use for identifying undervalued companies.

Traditional valuation methods alone are no longer enough to ensure a thorough assessment. In this environment, fundamental analysis has never been more important. The work to understand a company's growth strategy, accounting methods and history of capital deployment can help point investors to truly meaningful metrics for each company and industry.

Ultimately, the answer to today's questions about how to best identify value may be a combination

of methods. Investors willing to add a greater level of discernment in assessing relative value can be most effective by using a blend of traditional valuation techniques and more insightful analytical methods. Overall, investors will have a better gauge on whether a valuation is solid by starting with an understanding of

company dynamics and the resulting impact on items across the balance sheet, income and cash flow statements. As a result, they will be more fully informed about the meaning of more traditional valuation metrics and can make sure their investment decisions are aligned with the fundamentals of today's businesses.

**INSIGHTS** is a Glenmede Investment Management LP research paper. This issue was written by:



John Kichula, CFA<sup>®</sup>  
Portfolio Manager,  
Strategic Equity



Jonathan Lavy, CFA<sup>®\*</sup>  
Vice President,  
Portfolio Manager -  
Endowments and  
Foundations

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\*Jonathan is employed by GIM's affiliate, The Glenmede Trust Company, N.A.