Value Investing Is Not Dead, But It Is Harder

For quite some time, traditional value investing has not seemed to work. Even Goldman Sachs, the bluest of blue blood firms, recently wrote that "value investing is dead". There are many theories explaining the demise, but the most popular one was recently voiced by legendary value investor Jeremy Grantham in his first quarter letter to investors for 2017. In it, he tells investors, "This Time Seems Very, Very Different," and the famous perma-bear flips his long-time bearish script and argues that valuations may stay elevated for many years to come. Mr. Grantham succumbs, finally, to the idea that the old rules of value investing may no longer apply.

Mr. Grantham's arguments for the end of traditional value investing parallel those of many investors. They rest primarily on the assertions that both corporate profit margins and, consequently, valuations are permanently higher. Grantham says that he's done waiting for this divergence to resolve, and he's ready to accept a "new normal" of higher profit margins and valuation.

More rigorous analysis reveals flaws in those assertions, which suffer from reliance on accounting results that ignore financial footnotes and balance sheets. A more rigorous look at corporate profits shows them declining, not rising. Furthermore, when put into a richer historical context, stock valuations are rising, but they are still lower than anytime in the last 15 years.

We think today's market is the best in many years for value investors, the real value investors, that is. The real value investors analyze footnotes and balance sheets in addition to income statements.

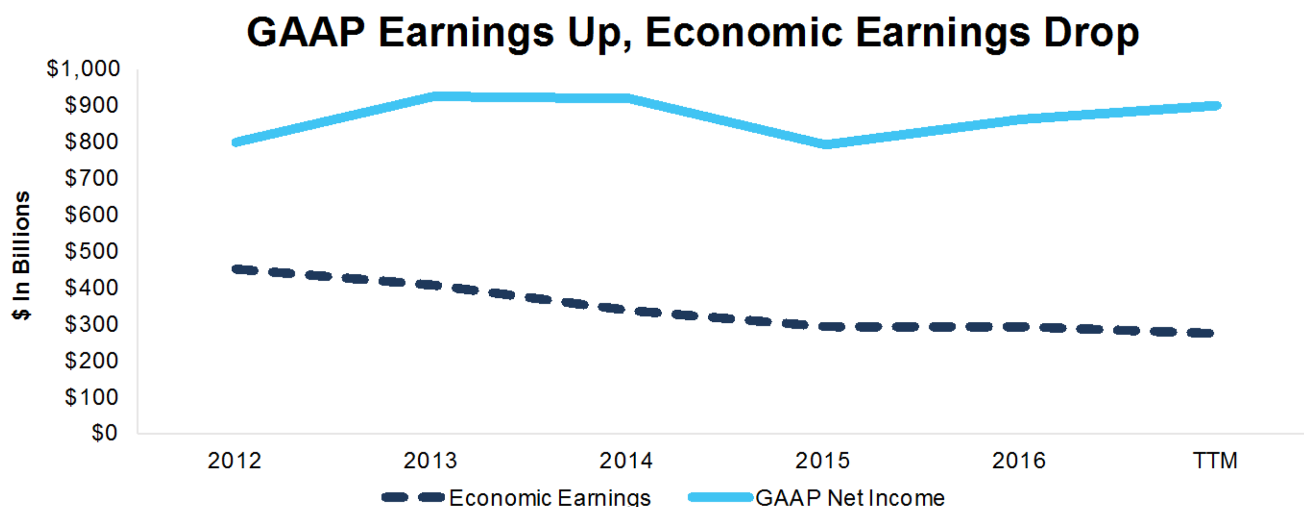
Flaw #1: Margins and Profits Are Much Higher Than Ever Before

Grantham's thesis on value investing no longer working starts with the assertion that the average profit margin for the S&P 500 is ~30% higher over the past twenty years than it was any time prior.

On the contrary, we see a real decline in corporate profits in recent years as we demonstrated in The Earnings Recovery Is An Illusion. The difference in our perspective and that of Mr. Grantham comes from our analysis of the footnotes and balance sheets in addition to the earnings numbers he gets from income statements.

Figure 1 shows the steady decline of economic earnings over the past few years even as reported earnings are up slightly.

Figure 1: GAAP Net Income Overstate Economic Earnings For The S&P 500



Sources: New Constructs, LLC and company filings.

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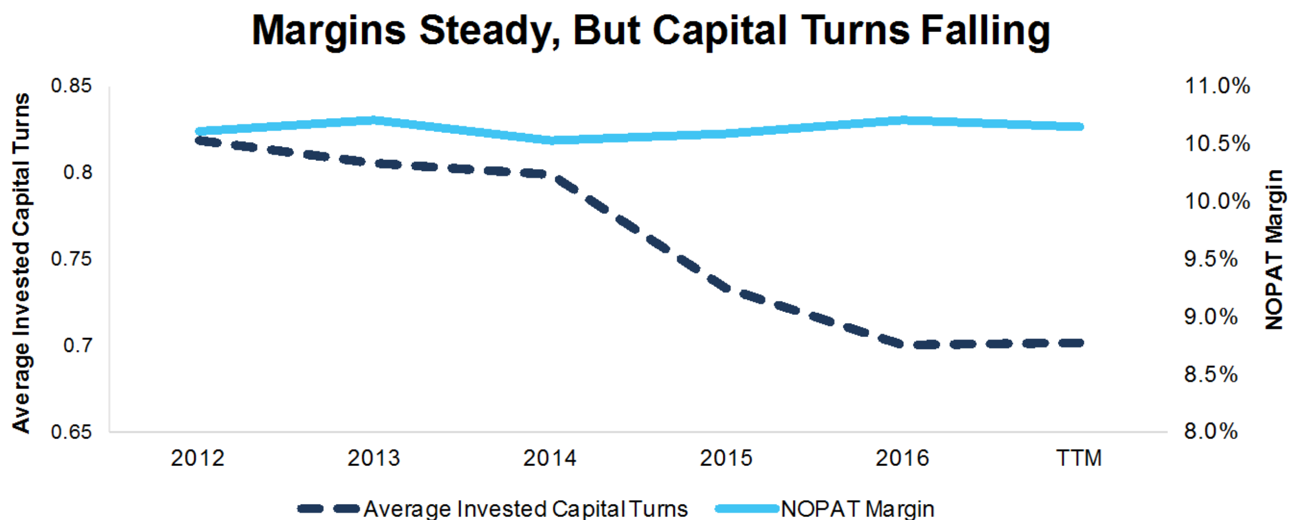
Grantham bases his conclusions on earnings reported under Generally Accepted Accounting Principles (GAAP). GAAP earnings contain numerous loopholes that companies can exploit to manipulate results. Only by digging through the financial footnotes and management discussion and analysis (MD&A) can investors reverse these accounting distortions to get an accurate picture of corporate profitability.

The same mistake is made by Goldman Sachs when they focus on the "value factor" or free cash flow. This metric is based on a simple concept, but an accurate calculation requires many complex and subtle adjustments to reported accounting results if you want both an accurate and apples-to-apples measure of free cash flow.

In addition to the issues with manipulation and comparability, accounting earnings only cover the income statement, which means they're only telling a fraction of the whole story. A truly comprehensive analysis of corporate profitability must focus on both the operating profit (NOPAT) generated by the company and the amount of invested capital (recorded on the balance sheet and in the footnotes) required to generate NOPAT.

Figure 2: NOPAT Margins And Invested Capital Turns For The S&P 500



Sources: New Constructs, LLC and company filings.

We don't have machine-readable filings going back far enough to completely test Grantham's claims, but Figure 2 does show that NOPAT margins have been flat over the past few years for the S&P 500. However, invested capital turns (i.e. capital efficiency as measured by dividing revenue by average invested capital) have declined.

Grantham makes some good points about the declining rate of business startups in the U.S. and how regulations create barriers to entry that protect the largest corporations. It does appear that these anticompetitive trends will allow big U.S. companies to hold on to some excess economic value, but Figure 1 suggests that competitive pressures have kept that value lower than Grantham believes.

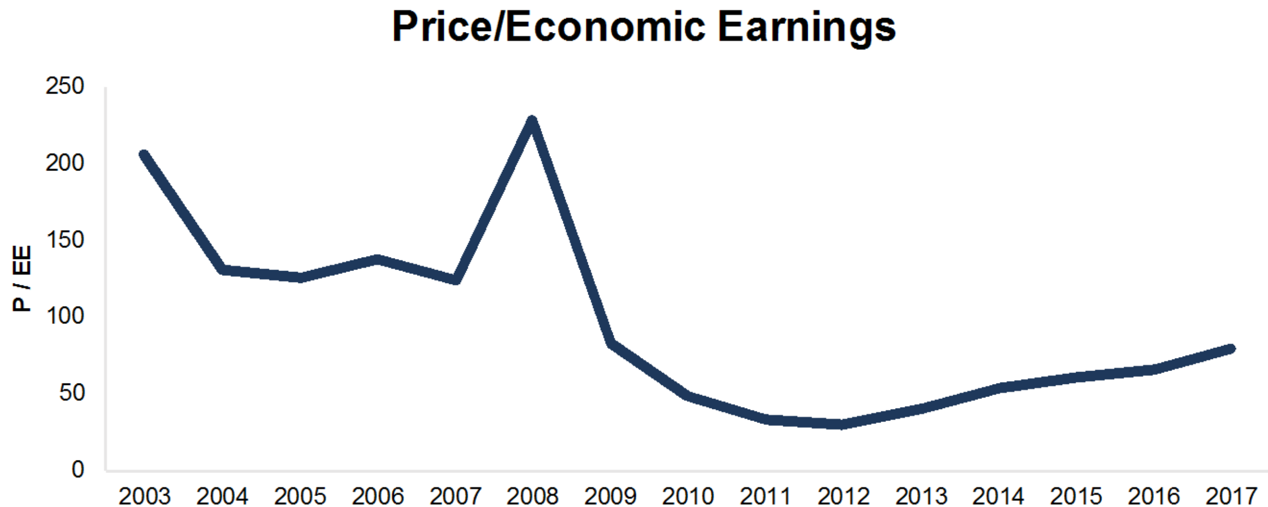
Flaw #2: Valuations Are Stretched

The next point in Mr. Grantham's argument that the traditional rules of value investing no longer apply is the observation that the average P/E ratio for the S&P 500 has been ~70% higher over the past twenty years than for the entire preceding period.

This flaw in this assertion is clear. If your denominator for the P/E ratio is off target, then your ratio cannot be accurate.

Rather than using the flawed accounting results for the P/E ratio, we focus on economic earnings as shown in Figure 1. Economic earnings measure the underlying economic performance of the business. This metric is comprehensive and captures the income statement, balance sheet, cash flow statement, footnotes and other disclosures. It is also leverages the latest in forensic accounting so it is free of accounting distortion.

Figure 3: Price To Economic Earnings For The S&P 500: Valuations Are Not As Bad Compared To Past



Sources: New Constructs, LLC and company filings.

On the face of it, Figure 3 doesn't look too troubling. The S&P's P/EE has more than doubled since 2012, but it's still below it's pre-08 levels (and so far below the tech bubble that we couldn't even include that era on the chart or it would throw off the scale).

However, when you look at Figures 1 and 3 together, the trend becomes more interesting. For several years now, stock prices and accounting earnings have risen while economic earnings have declined. While the overall market may not be as overvalued as Mr. Grantham suggest, it is clear that valuations for many stocks are getting too high.

Value Investing Matters More Than Ever

It's not just Mr. Grantham that focuses on accounting earnings; so do most investors. As a result, the market tends to be more focused on accounting earnings than economic earnings. In addition, accounting earnings are widely available for free. Economic earnings are not, and they require lots of work to calculate oneself (reading very 10-K and 10-Q cover to cover). So, we understand why so many investors, including Mr. Grantham, focus on accounting earnings instead of economic earnings.

However, heightened awareness of fiduciary duties by both investors and advisors is ushering in a return to the more diligent habits that underpin value investing, e.g. focusing on economic earnings. In addition, now that interest rates are no longer falling, markets no longer have the Fed to bail them out. We also think the reliance on technical research is at or past a cyclical peak.

These trends mean that the advantage gained from rolling up one's sleeves and doing the extra work to understand economic earnings is larger than it has been in many years.

The kind of companies for which investors should look in this environment are those where economic earnings are growing faster than accounting earnings, and where P/EE ratio reveals lower growth expectations than the P/E ratio suggests.

Toymaker Hasbro (HAS: $110/share) is a great example. The stock has more than doubled since our initial call in January 2015 and remains one of our top picks today. HAS has grown economic earnings by 9% compounded annually over the past decade, while accounting earnings have grown at an annual rate of just 6% over that same time.

Additionally, HAS has a P/EE of 31, significantly below the average for the S&P 500 (78), while its PE of 24 is right about at the average for the market.

Unlike most of the S&P 500, Hasbro's underlying drivers of valuation are better than the topline metrics. This disconnect is driven in part by items such as a $33 million impairment charge the company took last year that artificially decreased its reported earnings. Our robo-analyst technology helps us dig through the footnotes and reverse these accounting distortions not only for companies like HAS, but also for most public and private companies.

As valuations grow more and more stretched, this level of diligence becomes increasingly necessary. Investors have been able to make a lot of easy money in this market over the past several years. The easy-money trend could persist for a little while longer, but, eventually, economic reality will prevail especially as investors become more rigorous. We recommend that investors focus on companies like Hasbro that can thrive in this extended bull market while keeping risk lower because it has the underlying economic earnings power to survive the eventual rationalization between price and economic value.

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Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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