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Value Investing Redux

Global Matters Weekly

19 July 2021

– **Tom Delic**

Having been in consistent print since its first publication in 1949, Benjamin Graham's 'Intelligent Investor' has, along with 'Security Analysis', provided the philosophical foundation to thousands of successful investment practitioners over the decades. However, as Mark Twain said, "A classic is something that everybody wants to have read, and nobody wants to read". Open almost any page of those two texts however, and your mind will be enriched with the ideas and thoughts of Graham, and like most literature that has survived the test of time, you will soon realise why.

The concepts laid down by Graham over 70 years ago sets an investor up with a sound, rational, mental framework to deal with the vicissitudes of a hyper-active stock market, that swings between the emotions of a broken-hearted teenager and a toddler's first taste of chocolate. But what does Graham not say? Is the consensus view of value investing in line with the thinking of Graham or has time distorted and twisted the interpretation?

Leaning on the work of Eugene Fama and Kenneth French, investing is often reduced to nothing more than quantitative pigeonholing. A fund manager strategy or a point-in-time valuation ratio of a listed equity can then be boxed neatly into categories, pitted against one another in an endless race where investors are pressured to pick a side. Today, the consensus is "value" investing is losing the race, with "growth" investing in an unassailable lead. Perhaps though, there are no "style" sides and instead a footrace exists between investment and speculation, which can often feel like a marathon. This takes us back to Graham.

Graham's core tenets seek to teach us how to act like investors rather than speculators. The margin of safety concept sits at the heart of this approach and simply advises that the investor should only purchase securities where a gap exists between their conservative estimate of intrinsic value, and the price at which the security is being offered. In Graham's words, "the function of the margin of safety is, in essence, that of rendering unnecessary an accurate estimate of the future".

The example of Microsoft provides an illustrative example of Graham's concept in practice. From 1999 to 2012, Microsoft's free cash flow yield increased from 1.6% to 13.1%[1], with equity holders of the company suffering a -42% total return over the period[2]. The speculative era of 1999 had faded away and in 2012, an opportunity for a conservative investor was available.

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Value investing today is assumed to be a blind investment in the optically cheap but in 'Security Analysis', Graham emphasises that "an investment operation is one that can be justified on both qualitative and quantitative grounds". A cursory glance at the data in 2012 would have shown you that despite the share price halving since 1999, the business was fundamentally strong, with consistent revenue and cash flow growth over the period[3] and Microsoft Windows remaining the dominant operating system in an ever-increasing world of computer usage.

The narrative around the company was certainly not as rosy however, with headlines such as 'Microsoft's Lost Decade' and "Microsoft once ruled the world. So, what went wrong?" . Turning to Graham's principles once more, he states "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right." A margin of safety and the courage to act against the crowd would have resulted in a successful investment in Microsoft, as the investors of 2012 have handed the reins back to the speculators of 2020-21, which has seen the company move to a free cash flow yield of 2.5%.

In a period of frenzied and excitable divorcement of price and fundamental value, as we have seen over the past couple of years, the speculators rule the roost, with investors flapping for a perch. There is no universal law to help investors second guess when a change will occur. Instead, investors should stay focused on Graham's principles to ensure they are acting with a margin of safety using their own analysis. This is what value investing truly is.

[1][2][3] *Bloomberg Finance L.P.*

The **Marketplace**

- Global equities returned +0.1% last week
- US core inflation reaches its highest level since 1991
- Brent crude fell -0.7% last week to $73.6 per barrel
- Gold rose +0.8% last week to $1812.1 an ounce

Market **Focus**

US

- US equities rose +0.2% last week
- In Federal Reserve chairman Powell's testimony before Congress last week he stated that he views the US economy as "still a ways off" from the standard of having made the 'substantial further progress' in order to cut down asset purchases and reach employment and inflation targets. The FOMC will be discussing tapering at the next meeting in two weeks
- US retail sales for June surprised to the upside with a +0.6% increase (vs. -0.3% expected), but this was partly offset by a downward revision to the May reading
- Headline and core (excluding food and energy) consumer prices jumped +0.9% in June, roughly twice consensus estimates. Year over year CPI is now at +5.4% whilst core inflation is at 4.5%, which marks the latter's highest level in 30 years
- Initial jobless claims for the week through July 10 fell to a post-pandemic low of 360k, (vs. 350K expected)

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned +1.9% last week
- Japanese equities ended the week up +0.6%
- Chinese equities rose +3.4% last week
- China's Q2 GDP reading showed year-on-year growth at +7.9% (vs. +8.0% expected). June's data beat expectations, with retail sales coming in at a year-on-year growth rate of +12.1% (vs. +10.8% expected), while industrial production was up +8.3% (vs. +7.9% expected)
- The Bank of Japan's July meeting left short and long-term interest policy unchanged and unanimously agreed to maintain its asset buying program. The GDP forecast for this year was revised downwards to +3.8% from +4.0% in April, however growth in 2022 was raised to +2.7% from +2.4%

Europe

- European equities returned +0.8% last week
- Euro-area industrial production fell by a larger-than-expected -1.0% in May (vs. -0.3% expected)
- The final June CPI reading for the Eurozone showed prices rose +1.9%, unchanged from the initial reading
- ECB President Christine Lagarde said that next week's Governing Council meeting would focus on changing guidance on interest rates after the adoption of a new inflation target last week. She also said she did not expect "unanimous consent" at policy meetings "because there will be some variations, some slightly different positioning."
- France and the Netherlands have reimposed new restrictions around hospitality after a surge in Covid-19 cases

UK

- UK equities fell by -0.2% last week
- The CPI reading for June came in at +2.5% (vs. +2.2% expected), which is the highest rate of inflation in nearly 3 years. Food, fuel, clothing and second-hand cars were the key drivers
- The UK unemployment rate unexpectedly rose in the three months to May, coming in at +4.8% (vs. 4.7% expected), however, the number of payrolled employees saw a +356k increase in May
- England has lifted almost all remailing legal lockdown restrictions. Whilst the move is controversial, the government successfully hit its target of fully vaccinating two-thirds of the adult population by today, with 2/3 of adults having now received both doses and nearly 90% having had at least one dose
- Rightmove says the average asking house price is up almost +7% in six months as house prices rose +0.7% in July, the biggest increase for the time of year since 2007

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Asset Class/Region	Currency	Currency returns			
		Week ending 16 July 2021	Month to date	YTD 2021	12 months
Developed Market Equities					
United States	USD	0.2%	0.7%	15.8%	36.0%
United Kingdom	GBP	-0.2%	-0.1%	11.3%	15.8%
Continental Europe	EUR	0.8%	0.5%	15.6%	24.7%
Japan	JPY	0.6%	-0.6%	8.3%	25.0%
Asia Pacific (ex Japan)	USD	1.7%	-2.1%	4.6%	30.0%
Australia	AUD	0.1%	0.5%	13.5%	26.0%
Global	USD	0.1%	0.3%	13.4%	34.1%
Emerging markets equities					
Emerging Europe	USD	-0.4%	-1.5%	12.8%	28.3%
Emerging Asia	USD	2.0%	-2.6%	3.3%	30.0%
Emerging Latin America	USD	3.6%	-1.4%	7.4%	34.5%
BRICs	USD	2.8%	-3.3%	1.8%	21.6%
China	USD	3.4%	-4.7%	-3.0%	13.5%
MENA countries	USD	-0.1%	-1.1%	18.9%	36.9%
South Africa	USD	1.3%	-1.3%	9.0%	27.0%
India	USD	1.5%	1.1%	12.5%	51.3%
Global emerging markets	USD	1.9%	-2.3%	5.0%	30.5%
Bonds					
US Treasuries	USD	-0.1%	0.9%	-1.9%	-3.2%
US Treasuries (inflation protected)	USD	0.9%	1.5%	3.1%	7.0%
US Corporate (investment grade)	USD	-0.2%	0.8%	-0.5%	2.0%
US High Yield	USD	-0.1%	0.3%	3.9%	13.3%
UK Gilts	GBP	-0.1%	1.4%	-4.5%	-4.9%
UK Corporate (investment grade)	GBP	-0.1%	0.9%	-1.9%	2.5%
Euro Government Bonds	EUR	0.4%	1.2%	-1.9%	0.6%
Euro Corporate (investment grade)	EUR	0.2%	0.6%	0.2%	3.5%
Euro High Yield	EUR	0.1%	0.2%	3.3%	10.4%
Japanese Government	JPY	0.1%	0.5%	0.3%	0.4%
Australian Government	AUD	0.3%	1.5%	-0.9%	-0.5%
Global Government Bonds	USD	-0.1%	0.9%	-3.8%	-0.3%
Global Bonds	USD	-0.1%	0.6%	-2.9%	1.3%
Global Convertible Bonds	USD	-1.2%	-1.8%	-0.2%	16.4%
Emerging Market Bonds	USD	0.4%	0.8%	-2.3%	3.6%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 16 July 2021	Month to date	YTD 2021	12 months
Property					
US Property Securities	USD	2.5%	4.0%	26.1%	44.4%
Australian Property Securities	AUD	-1.1%	-0.9%	6.8%	26.6%
Asia Property Securities	USD	0.6%	0.3%	7.4%	14.3%
Global Property Securities	USD	1.6%	2.8%	17.0%	35.1%
Currencies					
Euro	USD	-0.3%	-0.3%	-3.4%	3.5%
UK Pound Sterling	USD	0.0%	-0.2%	0.9%	9.5%
Japanese Yen	USD	-0.3%	0.9%	-6.2%	-2.6%
Australian Dollar	USD	-0.4%	-1.1%	-3.6%	6.1%
South African Rand	USD	-0.6%	-0.5%	1.9%	16.1%
Swiss Franc	USD	-0.4%	0.7%	-3.7%	2.6%
Chinese Yuan	USD	0.2%	-0.3%	0.7%	7.9%
Commodities & Alternatives					
Commodities	USD	1.6%	-0.2%	28.1%	54.1%
Agricultural Commodities	USD	4.2%	-0.2%	19.6%	53.3%
Oil	USD	-0.7%	-2.0%	42.1%	69.7%
Gold	USD	0.8%	2.2%	-4.3%	0.6%
Hedge funds	USD	-0.1%	-0.1%	3.9%	11.0%

Source: Bloomberg. Past performance is not indicative of future returns

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