Odyssey Advisors, LLC
6701 Center Drive West
Suite 550
Los Angeles, CA 90045

Value Investors Never Pay Retail

By Anthony Diaz

Value investing is defined as the process where an investor selects companies whose stocks are currently undervalued by the market. Benjamin Graham is widely acknowledged as the father of modern security analysis, founded the school of value investing in the early 1900's, and influenced modern-day investing gurus such as Warren Buffett. Graham's value investing treatise *The Intelligent Investor* remains the seminal publication on the subject.

If a company with a solid history of good financials is being overlooked by the market in general, or if it is being beaten down by the market for temporary reasons (e.g. a new product launch is receiving tepid consumer reaction, a new movie is bombing at the box office, the CEO is undergoing heart surgery) a value investor regards this as a buying opportunity with the expectation that their prices will eventually rise to their true worth when the market adjusts itself or after the company's temporary issues or problems are remedied. This can take weeks or it can take years, but it is at that time when you have the potential of a capital gain. You must research your investment candidates and their industries thoroughly. You must also be willing to stand your ground when the pundits and the stock market in general say otherwise, and be able to let a stock go when you find that its fundamentals have changed significantly.

Most value portfolio managers screen first for fundamental measurements such as price-to-earnings (P/E) and price-to-book (P/B) that are lower than the S&P 500. They then analyze each company's financial statements. The key is not to invest in cheap stocks necessarily, but in those whose companies are currently undervalued by market over-reaction, misperception, and short-term focus, and whose stocks have catalysts for potential, long-term capital appreciation. This will only come from companies on a sound financial footing and with a good track record.

From this short list of undervalued, financially sound companies, you conduct a thorough qualitative evaluation. Review annual reports, SEC filings, press releases, and web sites, and talk to suppliers, customers, and competitors with the goal of truly understanding the companies—their management in particular—and the industries in which they operate.

It is preferable to invest in companies whose management has demonstrated long-term competency and integrity, and whose top executives have been in place a long time. What suppliers, customers, and competitors have to say about a company can be particularly revealing. If a company is on solid ground with their suppliers and customer base, this can be an advantage against their competitors. In contrast, if a company is constantly having difficulty with key suppliers or distribution channels, this could spell trouble going forward. Similarly, if customers are constantly complaining, or worse, defecting to the competition, this would not bode well. Finally, interviews with the competition can be a harbinger of a company's shifting competitive landscape in terms of changes in market share, target market, pricing power, and geographic penetration.

Value investing is very methodical, requiring equal doses of quantitative rigor and qualitative insight, and a great deal of patience since it's a challenge to identify these companies and it can take 3-5 years or longer before the market "bids up" a value stock to its true worth. As evidenced by Buffett's success and that of many others, however, value investing can be well worth the effort and the rewards can be great to those who commit the time and refuse to pay retail.

Anthony Diaz is Director of Research for Odyssey Advisors LLC, an independent investment advisory firm specializing in equities and fixed income. He can be contacted at adiaz@odysseyadvisors.com.

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