Are You an Investor or a Speculator?

Defining Value

by Ronald W. Chan and Brian C. Lui

Value, like beauty, is in the eye of the beholder. As "a beggar's dime is worth more than a king's gold," seeking value in the stock market is often subjective. Some investors think that a value stock should be a mature company; some think it has to trade at a low price-earnings ratio; and some believe that a high dividend yield is key.

In our first article on the subject, we'll define value investing and how it's applied. Before we begin, however, we must ask ourselves who we are when we purchase a stock — investors or speculators?

Investing and gambling traditionally have been viewed as being at the opposite ends of the spectrum, with speculating in between. An investor, through fine calculation, gains profit and earns dividends; the less reputable speculator or gambler, by skill or luck, gains only profit.

Benjamin Graham, the father of value investing, distinguished between investment and speculation: "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

Graham disciple Warren Buffett believes investing intrinsically encompasses the notion of value. In a letter to shareholders, he wrote: "The very term 'value investing' is redundant. What is 'investing' if it is not the act of seeking value at least sufficient to justify the amount paid? Consciously paying more for a stock than its calculated value — in the hope that it can soon be sold for a still-higher price — should be labeled speculation."

A low earnings multiple and high dividend yield aren't necessarily the determining factors of a value stock, Buffett said. A stock with a high P/E can also be cheap as long as its value is higher than its stock price.

People often separate value investing from growth investing as if they're opposing practices. This distorts the true nature of what value investors do. "The whole concept of dividing it up into 'value' and 'growth' strikes me as twaddle," says Charlie Munger, Buffett's business partner. "It's convenient for a bunch of pension fund consultants to get fees prattling about and a way for one adviser to distinguish himself from another. But to me, all intelligent investing is value investing."

Buffett spoke of value and growth in a softer tone and united the two strategies: "The two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive."

Simply put, value investing means buying a stock when it's trading at less than its fair value. In practice, investors must bear in mind that a stock certificate means part ownership of a company. Therefore, to be a good investor, one needs to think like a good businessman.

Company	Ticker	Price	Fair Value	Price to Fair Value
Cintas	CTAS	$30.96	$47.00	66%
Diageo	DEO	74.77	112.00	67
Expeditors International of Washington	EXPD	33.66	50.00	67
Exxon Mobil	XOM	73.26	106.00	69
Home Depot	HD	29.15	42.00	69
Lowe's	LOW	25.65	39.00	66
News Corporation	NWS	14.14	25.00	57
Paychex	PAYX	32.95	51.00	65
Time Warner	TWX	15.18	25.00	61

Fair Deals?
Stocks covered by Morningstar with five-star and wide-moat ratings and a price as of Sept. 10 that's less than 70 percent of the fair value, as calculated by the analyst covering the stock. Each stock's rating of fair value uncertainty is low.

Imagine that an investor wants to buy out an entire business. He obviously doesn't want to overpay, so the company's fair value is crucial. Stock investors should apply the same mentality.

In value investing terms, determining the fair value — commonly known as intrinsic value — is the first step to successful investing. A stock's intrinsic value is calculated from the economic value of its underlying business. Thus, a value investor needs to delve into a company's financial statements and analyze its competitive position, considering both tangible and intangible attributes.

Although there are many different models for deriving intrinsic value, the most common method involves the concept of discounted cash flow. This model measures the cash that can be taken out of a business during the remainder of its life and discounts the cash flow at an appropriate interest rate.

Intrinsic value calculations can vary widely depending on the growth and interest rates assumed. So value investors should treat intrinsic value more as a rough estimate than as a precise figure. In our next article, we'll explore intrinsic value's technical aspects. After all, value investing is half art and half science; therefore, a true investor needs to be prepared mentally and mathematically.

That said, Albert Einstein put it well: "Try not to be a person of success, but rather, a person of value!"

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