

## Taking Time Out

### AN INVESTOR'S APPROACH TO STOCK VALUATION

Most investors consider share price movement to be the critical factor in their decision to buy, hold, or sell any security. Many also have a fairly short-term time horizon for achieving price targets or for loss tolerance, before they sell out.

We believe that both of these views can be misleading, causing investors to make wrong decisions. This article is designed to throw some light on this issue by showing how a long-term value approach can succeed by taking time “out of the equation” and emphasizing business value instead of share price.

Readers are well familiar with the standard stock chart – presenting **share price** over a period of **time**: no wonder that most assume this has to be the default starting point for analysis and decisions.

Consider instead what a share price means. At any given point in time, it is simply the dollar amount which balances buyers and sellers. Essentially, it is the mid-point of a range where half the market participants think the stock is worth **more** than the current price (“undervalued”) and half think it is worth **less** than the current price (“overvalued”).

When the price moves, it is generally a combination of two factors:

- Information comes into the market (an earnings report, bid news, etc.) that leads most participants to change their perception of that stock's worth.
- A general market move that carries that stock price with it, to a greater or lesser extent. In essence, market participants are changing their aggregate view of what every business is worth. (These are moves that we believe are often carried to irrational extremes, offering great opportunities to rational investors).

Either way, at any moment, the stock price balances the overvalued and undervalued opinions. However, that tells us nothing about the **range** of opinions on this issue, and these patterns can be critical in assessing opportunities when they arise.

As an example, let's assume IBM's stock price is \$100. IBM is a well-researched company and the stock is widely held. If market participants were polled on what they thought IBM was truly worth, the center of that range, by definition, would be close to \$100, but the range around it would probably be relatively narrow, usually in a bell-shaped curve.

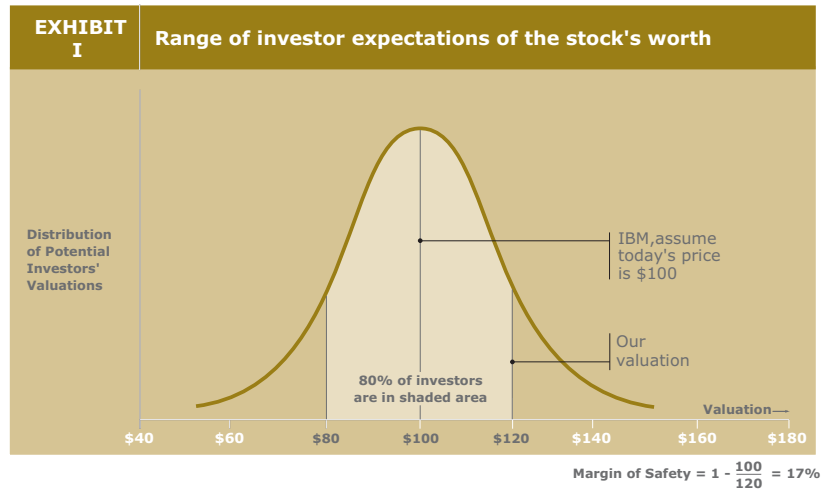
For example, not many would hold the view that the stock was worth over \$200, or under \$20. The estimates of most, perhaps as many as 80%, of market participants, would probably fall inside a range of \$80-\$120.

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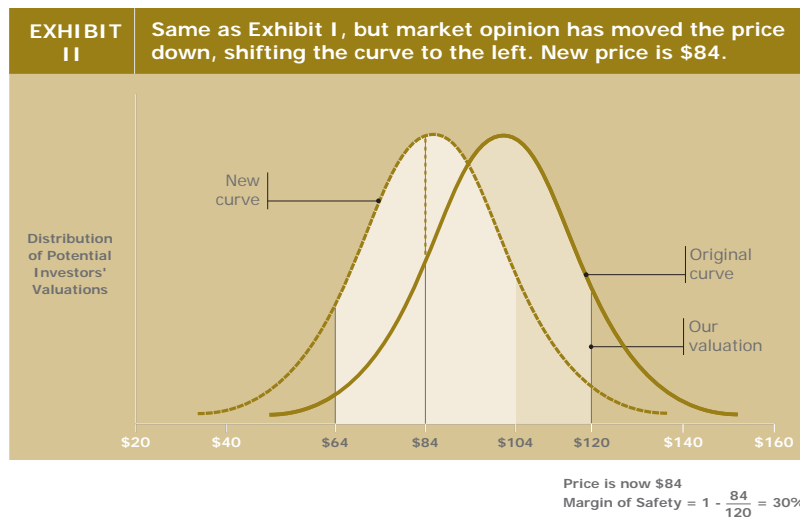
We have illustrated this in Exhibit I, assuming 80% of market participants' valuations fall in a range of \$80 to \$120.

As an independent-minded investor, we would have formed our own opinion of the underlying worth, or "intrinsic value" of IBM stock. Let's say we think it's worth \$120. With the price at \$100, it's undervalued, but it's only a 17% discount to the intrinsic value, and most value investors are likely to look for at least a 30% discount (or margin of safety) before buying.



Time is now irrelevant. We wait. If significant new information or analysis changes our assessment of the stock's intrinsic value, then we make an adjustment for that. If we assume, for simplicity, that hasn't happened, we'd buy only when the views of other market participants have changed enough that they move the whole curve so that the new, lower price is at least at a discount of 30% from our valuation of \$120 (that's a price of \$84 or below).

In Exhibit II, the distribution curve shifts to the left by \$16. Now we are assuming that 80% of market participants would assess IBM's worth somewhere between \$64 and \$104, which is the previous range, reduced by \$16.



Simple enough, but in practice, most liquid, large-cap stocks have fairly narrow bell curves, allowing only occasional opportunities to buy at a significant discount to what we perceive to be their intrinsic value.

This typically happens either when we have a strongly held opinion on the stock's value that differs from consensus, or when overall

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market conditions become highly volatile, intermittently pushing the stock price down to a 30% discount to what we believe to be its intrinsic value.

Both of these circumstances do occur, and occur sufficiently often to form the basis of an investment strategy for large-cap stocks, but both demand the investor to be patient, to hold views with conviction, and to be prepared to act when the discipline requires it.

Now let's consider two other types of stock opportunity.

For smaller, less-researched stocks, the bell curve broadens out. In other words, the range of market participants' opinions of the stock's worth in the market may be much wider than for a typical large-cap stock.

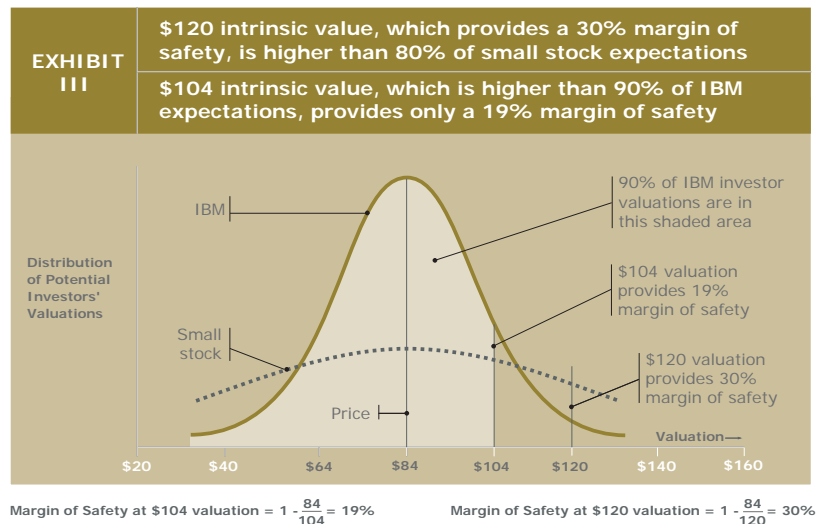
If we assume that the smaller stock's price, at \$84, is the same as IBM's, the proportion of market participants believing that the stock's true worth is at least 30% or more away from that price may be high compared to the narrower distribution of valuations for a large-cap stock such as IBM.

The broader dispersion represents a greater degree of uncertainty, or lack of

knowledge, by market participants about the underlying worth of the company. Thus, by diligent fundamental research, we may be able to identify among smaller stocks a larger proportion of such stocks where we believe the intrinsic value is well above the current stock price.

Additionally, the potential discrepancy between our estimate of intrinsic value and the market price may sometimes be wider than for stocks like IBM with more detailed analytical coverage.

To contrast this small stock opportunity with larger stocks, consider the mathematics. Given the narrower bell-curve for a typical large-cap stock, even if our estimate of intrinsic value is higher than 90% of the values estimated by other market participants, this intrinsic value of \$104 provides a margin of safety of only 19%. For a small cap trading at that same \$84 price, with a broader range of expectations as illustrated in the flatter bell curve of Exhibit III, the intrinsic value required for a 30% margin of safety may not have to be so extreme relative to others' views. In this example, that 30% margin of safety, which requires an intrinsic value of \$120, may only need to be higher than 80% of others' expectations.



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A second example, which was particularly common in the post-2000 bear market, is the so-called “toxic stock.” These stocks have dropped sharply in price, to the extent that many investors will not own the stock, either because they really believe it’s worthless, or because they will not accept the “professional risk” of owning it. In this latter case, professional money managers may believe there is a significant chance that the stock is indeed undervalued, but as there also seems to be a chance that it may not survive, they aren’t prepared to take the professional career risk of owning it.

This effect is researched separately in the Brandes Institute paper *Buying the Wrong Stock for the Right Reason*. For the purposes of this article, the important fact to note is that such investors act as though the stock is worthless, even if they don’t actually believe that to be the case.

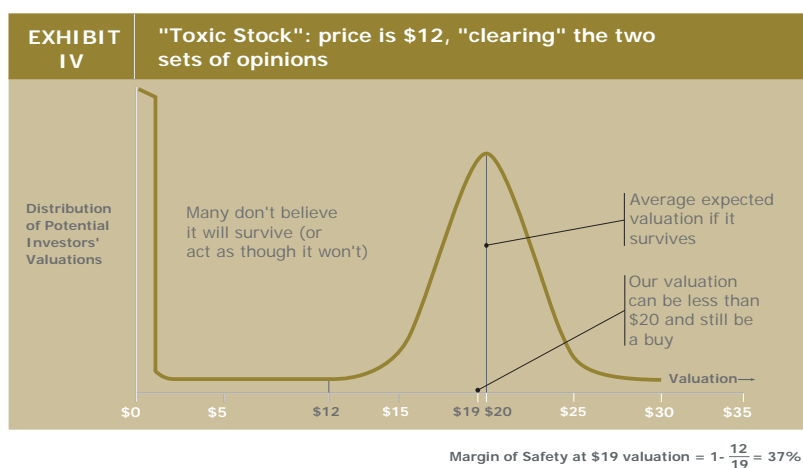
This leads to an interesting shape of the curve of investors’ expectations as shown in Exhibit IV. While many investors still value the stock with a positive intrinsic value, a significant number attribute a zero value (or act that way, with an identical effect).

As a result, the price (which is merely the average that “clears” investors’ expectations) will be in the middle of this range. In this example, the price is \$12. Interestingly, very few investors actually believe this price is what the company is worth – they’ll either expect it eventually to be worth significantly more, or they expect it to go to zero. This is an unstable distribution, which is likely

to last only as long as there is still “career risk” perceived in holding the stock. Eventually the curve will move back to the more normal distribution bell curve. This will likely either be centered around the \$20 value or close to zero.

The implications for a value investor are clear. If our analysis suggests that such a toxic stock will indeed survive and does in fact have a positive intrinsic value, then it is highly likely that our assessment of intrinsic value will provide a substantial margin of safety compared to the current price.

The caveat is that the risk of bankruptcy in owning such toxic stocks is in fact significant. Thus, while it may be a highly profitable strategy, it should be implemented prudently, by limiting the amounts exposed to such stocks, by demanding a higher margin of safety, and/or by diversifying across a number of “toxic” situations.



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In conclusion, we have identified three different types of margin of safety opportunities. These, along with their characteristics, can be summarized as follows:

Type	Opportunity	Frequency
Large Cap	Contrarian value view, but based on well-known information Market volatility	Intermittent
Small Cap	Superior analysis	Frequent
Toxic Stocks (small or large cap)	Confidence in own analysis Acceptance of "professional risk"	Periodic, but especially common in bear markets due to participants' "fear aversion"

In each of these situations, we have demonstrated that a key element of the investment decision should not be the time axis, but the relationship between the value and the price for each stock, without regard to the time factor. Superior overall performance should result if an investor "anchors" the decision process based on a fundamentally derived valuation, and then waits patiently for the price to move to an appropriate purchase level offering an adequate margin of safety.

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