Session 12

Introduction to Value Investing

Test

1. Which of the following is the best characterization of a “value” investor?
    a. An investor who cares about value and finding undervalued companies.
    b. An investor who incorporates fundamentals into his or her valuation judgment.
    c. An investor who buys stocks that trade at low PE ratios.
    d. An investor who buys stocks that trade at less than book value.
    e. An investor who wants to buy a company for less than the value of just its assets in place.
2. If you are a value investor, which of the following statements best characterizes your view of growth opportunities?
    a. Growth opportunities don’t usually exist.
    b. Growth does not add to value, since companies have to reinvest to generate growth
    c. Growth is too speculative and thus should not be paid for.
    d. Growth can add value, but if it does, it should be viewed as a bonus on the investment, not as the reason for the investment.
    e. None of the above
3. Ben Graham’s screens for value stocks have been modified and adapted over time. Which of the following types of companies do the Graham screens try to find?
    a. Cheap companies that pay high dividends, have low risk and reasonable growth prospects.
    b. Cheap companies that generate high and stable earnings, with little growth.
    c. Cheap companies that will have high growth in the future, while paying some dividends.
    d. Cheap companies that have very little debt.
    e. None of the above.
4. Warren Buffett is a legendary investor, and investors have long followed his maxims on investing. Which of the following types of companies has he generally favored as investments?
    a. Companies with simple businesses that are easy to understand.
    b. Companies with strong competitive advantages (moats) and high returns on investments.
    c. Companies with strong balance sheets and solid (and stable) cash flows.
    d. Companies with good managers that you can trust.
    e. All of the above
5. If you want to replicate what Warren Buffett has done in today’s markets, which of the following is the biggest impediment that you will face?
    a. Markets have become efficient and stocks are not mispriced any more.

b. Everyone has access to information at the same time.
c. Companies no longer have strong competitive advantages.
d. All of the best companies are in businesses that are difficult to understand.
e. Your clients may not have the patience to allow you to make long-term bets.

Solution

1. Which of the following is the best characterization of a "value" investor?
    a. An investor who cares about value and finding undervalued companies.
    b. An investor who incorporates fundamentals into his or her valuation judgment.
    c. An investor who buys stocks that trade at low PE ratios.
    d. An investor who buys stocks that trade at less than book value.
    e. An investor who buys companies for less than the value of just its assets in place.

Explanation: While services may classify value investors as those who buy stocks with low PE and low PBV ratios and value investors may believe that they are the only ones who care about intrinsic value, in my view, value investors differentiate themselves by focusing on valuing assets in place and buying those assets at a bargain price.

2. If you are a value investor, which of the following statements best characterizes your view of growth opportunities?
    a. Growth opportunities don't usually exist.
    b. Growth does not add to value, since companies have to reinvest to generate growth
    c. Growth is too speculative and thus should not be paid for.
    d. Growth can add value, but if it does, it should be viewed as a bonus on, not as the reason for, the investment.
    e. None of the above

Explanation: Most value investors will accept the proposition that growth exists and that it can add value to a company. However, they would prefer to receive this growth value as additional premium, rather than be the primary reason for investing.

3. Ben Graham's screens for value stocks have been modified and adapted over time. Which of the following types of companies do the Graham screens try to find?
    a. Cheap companies that pay high dividends, have low risk and reasonable growth prospects.
    b. Cheap companies that generate high and stable earnings, with little growth.
    c. Cheap companies that will have high growth in the future, while paying some dividends.
    d. Cheap companies that have very little debt.
    e. None of the above.

Explanation: The Graham screens are built around finding cheap companies that pay high dividends, are low risk (with low debt and stable earnings) and some earnings growth.

4. Warren Buffett is a legendary investor, and investors have long followed his maxims on investing. Which of the following types of companies has he generally favored as investments?
    a. Companies with simple businesses that are easy to understand.
    b. Companies with strong competitive advantages (moats) and high returns on investments.
    c. Companies with strong balance sheets and solid (and stable) cash flows.
    d. Companies with good managers that you can trust.
    e. **All of the above**

Explanation: Buffett's maxims have pushed him towards companies that have products or services he understands (credit cards, newspapers, soda etc.), strong brand names and/or other competitive advantages and managers that he trusts.

5. If you want to replicate what Warren Buffett has done in today's markets, which of the following is the biggest impediment that you will face?
    a. Markets have become efficient and stocks are not mispriced any more.
    b. Everyone has access to information at the same time.
    c. Companies no longer have strong competitive advantages.
    d. All of the best companies are in businesses that are difficult to understand.
    e. **Your clients may not have the patience to allow you to make long-term bets.**

Explanation: Buffett's investments have not always paid off right away. While he has the complete trust of his investors, a money manager who tries to invest in Buffett might not. Consequently, he may find himself out of business or a job even though his bets may pay off in the long term.