Monday, March 4th, 2019

"Value Matters – But, Book Value Doesn't"

To Focused Compounding Free Members:

A little over a week ago, Warren Buffett put out his annual letter to Berkshire Hathaway shareholders. In that letter, Buffett abandoned his 50-year tradition of opening with a sentence describing Berkshire's increase (or decrease) in book value per share. Why? Because Berkshire is buying back stock. And it is buying that stock back at a price greater than book value. When a company buys back its own stock at a price ***below*** book value – book value per share increases. But, when a company buys back its own stock at a price ***above*** book value – book value per share ***decreases***. So, Warren Buffett – by buying back Berkshire Hathaway stock above book value – is doing something that will, by definition, lower the book value per share of his stock. Why would Buffett do that? Value investors have – since the early days of Warren Buffett's teacher, Ben Graham – used something called the "price-to-book" ratio. This isn't the only measure value investors have used. But, it is the measure that academics who study value investing focus on. It's also the most commonly used measure for deciding whether a stock belongs in a "value" or "growth" index. But, here's the thing: book value doesn't matter. Now, the ***price***-to-book ratio does matter. But, that's because the price-to-***anything*** ratio matters. Think about it. Wouldn't you rather buy a stock at a lower price-to-earnings ratio, price-to-sales ratio, price-to-premiums ratio, price-to-deposits ratio, price-to-inventory ratio, price-to-receivables ratio, price-to-square foot ratio, price-to-acre ratio, price-to-tons ratio, price-to-customers ratio, and so on. Warren Buffett said it best:

"Price is what you pay; value is what you get."

The one ratio that matters is the "price-to-value" ratio. Book value can be a helpful approximation of value. But, only in some cases. The better a business is, the older a business is, and the more a business has grown "organically" (by building its own brands, producing its own movies, launching its own software, etc.) the less useful a measure book value becomes. It's not helpful to know what a company paid for the land it owns if it bought that land 100 years ago. Academics may not be able to do better than book value. But, we stock pickers can do a lot better than academics when it comes to figuring out what the price-to-***value*** ratio of a stock is. I recently read an annual report with this line in it: *"Book value per share…was $7.88 on a historical cost basis…the value per share…assuming that the property valuation (of the company's main asset) is used, would be approximately $16.26 per share."* Imagine that stock is trading at $8 a share. It's selling at a slight premium to book value. But, it's also selling for less than half of the value a real estate appraiser would put on the actual assets the company owns. So, isn't it a value stock? In fact, isn't it more of a value stock than many companies trading below book value? And: if Warren Buffett – the world's best known value investor – is buying back his own company's stock above book value, doesn't that mean he thinks Berkshire is a value stock even above book value? And why wouldn't he? Berkshire owns a lot of insurance companies. One of them is GEICO. Berkshire carries GEICO at the cost it acquired the company for (24 years ago) plus the earnings GEICO has retained while Berkshire owned it. Meanwhile, the ***stock market*** values GEICO's closest competitor – **Progressive (PGR)** – at 4 times book value. That's one of the reasons why Berkshire can be a value stock at prices above book value.

So, don't rely on websites to tell you how cheap a stock is. The one price ratio that matters is the one you have to calculate for yourself – it's the price-to-***value*** ratio.

Sincerely,

Geoff Gannon

As a Focused Compounding free member you get access to this week's free post: ***Universal Robina: A Good, Growing Filipino Branded Food and Drink Business – That's Not Quite Cheap Enough for Value Investors***

To get access to everything Focused Compounding has to offer, go to ***focusedcompounding.com*** *and enter the promo code "memo" to save $10 a month off a premium membership.*

And, if you'd like me to manage your money – email my partner, Andrew Kuhn, at ***info@focusedcompounding*** *or call or text him at* ***469-207-5844****.*

Focused Compounding Capital Management is now able to manage (sub-manage) money for institutions and RIAs as well as individuals.