Ball (BLL): A Debt Laden, Economic Value Obsessed Organization with a Super Wide Moat

Gaia (GAIA): A Strange Value Investment in a Streaming Service

Revisiting Keweenaw Land Association (KEWL)

Tuesday, April 2nd, 2019

How to Find a Stock You Can Afford to Hold

To Focused Compounding Free Members:

In a blog post I wrote this week, I discussed the difference between a stock's "hold return" and a stock's "trade return". This is an important concept for value investors, because the big divide between the Warren Buffett camp of value investors and the Ben Graham camp of value investors is over this issue of how long you can afford to hold a stock that is trading at a discount to its intrinsic value. The Ben Graham camp of value investors like to quote a statement Graham made to the U.S. Senate. He was asked:

"When you find a special situation and you decide…that you can buy it for 10 and it is worth 30, and you take a position, and then you cannot realize it until a lot of other people decide it is worth 30 – how is that process brought about, by advertising or, what happens?"

To which Graham replied:

"That is one of the mysteries of our business, and it is a mystery to me as well as everybody else. We know from experience that eventually the market catches up with value."

Now, all value investors – both those in the Buffett camp and those in the Graham camp – agree with what Graham said ***in principle***. But, I find that many value investors of the Buffett camp don't agree with Graham's statement ***in practice***. That is, they don't put their money where Graham's mouth was.

Let me take as an example a stock I was looking at this past week. The stock trades at a meaningful discount to the sum of the fair value – that is, the estimated market value – of its parts. Different analysts will come up with different estimates of how meaningful that discount is. But, some have estimated the discount is about 70%. That's basically the same as the hypothetical example the Senator posed to Graham. You find something worth $30 and you buy it for $10. Graham said it eventually goes to $30. That "the market catches up with value". But, the value investors in the Buffett camp will say that holding such a stock for the long-term doesn't pay off if the stock doesn't compound its value quickly and the gap between market price and intrinsic value stays wide for a long time. The good news is we can settle this with some math. Assume the stock trading at $10 a share retains all its earnings and grows intrinsic value at just 3% a year (keeping pace with inflation). Meanwhile, it takes 20 years for the market price to catch up with stock's intrinsic value. What's your return over those 20 years? It's 9% a year. That's no worse than an index fund is likely to do. In other words, the Ben Graham investor can afford to wait 20 years for the market to catch up to value as long as he pays just one-third of the value of the stock. If the gap between price and value closes quicker, the Graham investor beats the market.

Sincerely,

Geoff Gannon