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Recommended Citation
Johnson, Robert R. PhD; Robinson, Thomas R. PhD; and Horan, Stephen M. PhD, "Deep Value Investing Has Not Gone Out of Style" (2017). Faculty Publications. 678.
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Deep Value Investing Has Not Gone Out of Style

Robert R. Johnson, Ph.D., CFA, CAIA, Thomas R. Robinson, Ph.D., CPA, CFP, CFA, CAIA and Stephen M. Horan, Ph.D., CFA, CIPM

Article Highlights

- Benjamin Graham defined stocks trading with a large margin of safety as those whose prices were below net working capital after all debt was deducted.
- Graham found that a portfolio of such bargain issues outperformed the broader indexes, with none of the 150 identified stocks incurring significant losses.
- An updated version of Graham’s Deep Value screen was created in 2012; through November 2016, the portfolio beat the S&P 500 with all its stocks achieving positive returns.

Sound too good to be true? In the 1957 edition of “The Intelligent Investor,” Graham identified about 150 stocks that met that criterion. He tracked the performance of those firms over the following couple of years and, while he didn’t provide details, found that this portfolio of bargain issues outperformed the broader indexes. Perhaps more importantly to the value investor, he reported that none of the firms he identified showed significant losses. That is, the bargain issues indeed provided a margin of safety for investors.

Realize that Graham presented this methodology nearly 60 years ago. Surely, with all of the databases and the intense scrutiny and increasing sophistication of the financial markets today, there cannot be many instances of companies selling for less than net working capital after deducting all debt. Can these opportunities still exist?

**Rerunning Graham’s Strategy**

In our book “Strategic Value Investing: Practical Techniques of Leading Value Investors” (McGraw-Hill Education, 2014), we ran the Graham Deep Value screen and identified stocks that met the criteria as of January 27, 2012. Our screen used AAII’s Stock Investor Pro fundamental stock screening and research database and sought out stocks trading at prices below their net current asset value. Stock Investor Pro defines net current assets per share as current assets less total liabilities and preferred stock divided by the average number of shares outstanding for the last fiscal quarter. We also required...
As you can see, some of the bargain issues sold at a much greater discount from net working capital less long-term debt than others. The average discount for the nine securities was 16.9%. The deepest bargain issue was Paradise Inc. (PARF), selling at a 41.4% discount. At the other extreme, Flexsteel Industries Inc. (FLXS) was only selling at a 0.5% discount from net working capital less long-term debt.

While the list we identified is much shorter than the one Graham found in 1957, we were able to identify nine bargain issues. They are shown in Table 1 below as well as on page 190 of our book.

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### Checking the Returns

So, how did these securities perform over the next approximately five years? Table 2 provides a recounting of how each firm fared over this period. The return on the S&P 500 index over this period is also provided for comparison.

For the return analysis we used current data from Yahoo Finance, which computes a dividend and split-adjusted purchase price. This allows a simple return to be computed by taking the current price divided by the adjusted purchase price, which considers any stock splits or dividends occurring over the period. We also checked Yahoo Finance's computation by looking at the dividends and splits and performing an internal rate of return computation for the period.

An equally weighted portfolio of the nine Deep Value stocks would have returned 106.4% from February 29, 2012, through November 30, 2016. This return compares quite favorably with the 78.3% gain by the S&P 500 total return index over that period. The dispersion of returns was wide, ranging from the over 250% increase on Flexsteel Industries Inc. to the 43% return on Paradise. However, one of the most interesting findings is that each of the nine companies we identified provided a positive return and the majority exceeded the return on the S&P 500 on their own. Similar to Graham's original findings, this is evidence that the Deep Value screen provides the investor with a substantial margin of safety.

While certainly not an exhaustive study, it appears that recent results from the Deep Value screen provide evidence that some investment strategies simply don’t go out of style. It appears profitable for investors to purchase firms in which they essentially can acquire the fixed assets and any goodwill for free.

### A Caveat

One major caveat is that market sentiment plays an important role in how many deep value investment opportunities exist at any given time in the marketplace.

At the time of publication of the 1957 edition of Graham’s “The...
Intelligent Investor,” the S&P 500 was trading at a price-earnings ratio of 12 to 13 times. In contrast, when we ran our screen in early 2012, the S&P was trading at a higher price-earnings ratio of between 15 to 16 times earnings.

As of this writing, the S&P 500 is trading at a price-earnings ratio of about 21 relative to its long-term average of 15. So it may be the case that there are fewer deep value investment opportunities today than there were four years ago.

But value investing is cyclical. Opportunistic investors are well advised to periodically revisit the screen. Good things come to those who wait.

**What Now?**

Given that price-earnings ratios are higher than their historical average, what’s a strategic value investor to do?

Seth Klarman may be able to provide some guidance. He advocates maintaining cash reserves during relatively high valuation periods, especially when value investing opportunities may be rare. It’s not so much a market timing strategy as it is a technique to keep his powder dry so he has some ammunition when value opportunities do present themselves. This strategy worked out very well for him when the market collapsed from 2007 to 2009. It does require to the discipline to stick to a contrarian approach, which can often be at odds with how your emotions will want you to act.

Successful value investing requires discipline and independent thinking. If your valuation metrics are not producing many investment opportunities, it can be a sign that there are fewer stocks trading at bargain prices.

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**Defining Net Current Assets per Share**

Net current assets is the value of cash and assets easily convertible to cash within a short period of time less debt and preferred stock. Current assets consist primarily of cash and cash equivalents, receivables and inventories. The formula used for calculating net current asset value (NCAV) for the most recent quarter in *Stock Investor Pro* is:

\[
\text{NCAV} = \frac{\text{Current assets Q1} - (\text{Total liabilities Q1} + \text{Preferred stock Q1})}{\text{Average shares outstanding Q1}}
\]

NCAV differs from working capital by excluding both long-term liabilities and preferred stock. Working capital, in contrast, is simply current assets less current liabilities (to convert it to a per share number, divide the result by the average number of outstanding shares). The stricter NCAV is a proxy for the liquidating value of the company, with the idea being that the share price gives investors enough of a buffer to provide a return on investment should the company go under.

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**The Graham Deep Value Screen: Stock Investor Pro Criteria**

The screen run in 2012 for this article sought out companies trading below their net current asset value. The companies were also required to be profitable and have realized positive cash flow over the past five years. The exact criteria used to screen for these companies in *Stock Investor Pro* are:

<table>
<thead>
<tr>
<th>Field</th>
<th>Operator</th>
<th>Compare to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>&lt;=</td>
<td>Net current assets per shr Q1</td>
</tr>
<tr>
<td>EPS-Continuing 12m</td>
<td>&gt;</td>
<td>0</td>
</tr>
<tr>
<td>Cash from operations 12m</td>
<td>&gt;</td>
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<tr>
<td>Price</td>
<td>&gt;=</td>
<td>5</td>
</tr>
</tbody>
</table>

As of November 30, 2016, just two stocks pass this screen, McRae Industries (MCRAA) and Paradise (PARF). As shown in Table 1, both stocks also passed the screen in February 2012. The two companies have remained profitable and cash flow positive. Both McRae Industries and Paradise do, however, trade over-the-counter with very low volume.

—Charles Rotblut, CFA

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