The View *from* Burgundy

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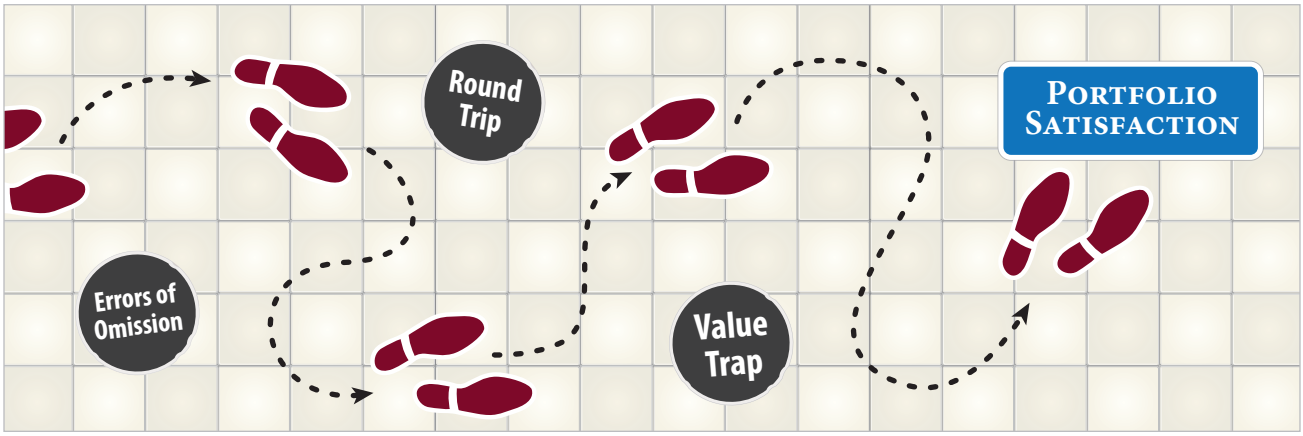

Ain't Misbehavin'

Value investing is simple: buy stocks when they are trading for less than their intrinsic value. But simple doesn't mean easy. There are many roadblocks standing in the way of investment success.

There are three pervasive errors that value investors make repeatedly. In this edition of *The View from Burgundy*, we will identify these mistakes and suggest some common causes. We will then develop a framework to help minimize the errors, with help from a new book by economist Richard Thaler as well as observations of Ben Graham and Warren Buffett's respective approaches. Following in the footsteps of these value investing trailblazers should lead to less investor misbehaving.

Pervasive Errors

What are these three errors? The first mistake is failing to buy the shares of a great company as it is swooning, in the hopes of getting it a little cheaper, when instead it rebounds. You end up standing pat and watching it compound its intrinsic value and shareholder return at superior rates for many years into the future. It becomes a huge missed opportunity. Warren Buffett calls these mistakes "errors of omission."

The second error is to successfully make an investment buy, only to fall in love with the company as its stock price gets extended, thus failing to sell when the stock becomes fully valued. You then ride the position all the way back down again. A "round trip." The missed opportunity in this case was an investment sale that never occurred.

The third error is to invest in a "value trap." These are cheap stocks that stay cheap or get cheaper when the company's intrinsic value falls after the investment is made.

Experienced value investing practitioners have made each of these mistakes many times. Finding a way to reduce these three repeated errors is worth money in investors' portfolios. One idea about how to encourage better investor behaviour comes from Richard Thaler's new book, *Misbehaving*.[i]

Thaler wrote *Misbehaving* to memorialize a career helping uncover behavioural economics.

This sub-genre of the dismal science and its related field of study, behavioural finance, arose in the last few decades after the basic assumption underlying economic theory – that people are rational, unemotional and gifted natural statisticians when making choices – proved to be false. Instead, according to Thaler and the other behaviourists, we humans are guilty of systematic and predictable errors by relying on imprecise rules of thumb, anecdotes and stereotypes when making decisions. We are not pure optimizers with perfect information.

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Two Types of Utility

Thaler identifies two types of utility. In economics, utility is a term used to measure satisfaction or usefulness. While impossible to measure precisely, utility is what all of us are targeting. For investors, since more wealth equates to more usefulness, better long-term returns generate more utility.

Acquisition Utility

Thaler calls his first type of utility acquisition utility. In economics-speak, it is the amount of satisfaction one gets, minus the price of obtaining that satisfaction. It is similar to the economic concept of consumer surplus, which measures the difference between what a consumer would have paid for a product less the actual price. So if you as a consumer value a product far more than the price paid for it, you will enjoy an abundance of acquisition utility by buying it.

Acquisition Utility
perceived value > market price

A "fair" price for a given product is known because it can be seen in the marketplace. A consumer who has long-term expectations for the value of the product exceeding that fair, or market, price can create acquisition utility by purchasing it. Most teenagers who purchase the latest iPhone with their part-time job earnings or allowances can attest to this. Owning a product that you can't live without, no matter the price, makes for a lot of satisfaction.

Transaction Utility

In contrast, consumers do not feel that most products are worth more than the "fair" or typical price they sell for. In the majority of cases, buyers try to pay less than, and only up to, a price level that is deemed "fair." And any time consumers can buy one of these desired products for less than what it normally sells for, satisfaction arises. Thaler calls this second type of satisfaction transaction utility.

Transaction Utility
purchase price < fair price

Transaction utility is all about getting a deal. It is generated when you can buy a product for less than its typical fair price. So if you can purchase a tube of toothpaste for $2 that usually sells for $4, you enjoy some transaction utility.

Acquisition and Transaction Utility in Investing

Now let's apply both of Thaler's utilities to investing. Recall that acquisition utility is the satisfaction generated when you value a purchase a lot more than the price it is selling for in the market. With investments, this occurs when investors identify value that they expect will emerge over a long time period as the company grows in monetary worth. Because this value is beyond any obvious statistical measures, it is less visible. Acquisition utility is created with the purchase because buyers expect that long-term returns will be generated as the value of the investment grows over many years.

What about transaction utility? Investors generate some transaction utility on a stock when the price paid makes it a statistical "bargain" purchase. It is a good deal. This bargain can occur if any or all of the price/earnings ratio, price/book value ratio or dividend yield, for example, are at much more attractive levels than typically found for that kind of stock. The satisfaction arises because buyers expect that, given the bargain price, positive investment returns will be earned if the statistical valuation metrics eventually return to more typical levels as the share price moves higher.

While these two types of investment utility are both the result of an expectation of future returns, they are not the same. Transaction utility is all about getting a deal. You go to the store for shampoo and notice dishwasher detergent is on sale, so you buy it too. Your friends and neighbours would probably all agree that it's a deal, and the satisfaction comes from the price discount, not from expectations of future utility.

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The same is true with a cheap stock. Not all will have the stomach to catch the falling knife and make the bargain purchase, but most will probably agree that the price is statistically cheap when compared to historical norms. Cheap stocks feel like good deals.

In contrast, acquisition utility is like the satisfaction that comes when you are able to buy a home of the right size and style, in the right neighbourhood, which you plan on enjoying for many, many years. Ten different people would likely have 10 different opinions and levels of utility about the purchase. Some with different tastes and living plans would even feel the home is overpriced. But your mind creates personal acquisition utility, along with a sense of ownership, because you can imagine the long-term satisfaction that will come from inhabiting a great home that perfectly suits your needs for many years.

Investors targeting acquisition utility have the same mindset. Because a great company's attractiveness is harder to prove statistically than the cheap stock discussed above, fewer people will agree that it represents value. But in this case, buyers feel that growth in the investment over time will eventually justify their purchase as a long-term bargain. In economics-speak, they see the present value of the company's future value creation to be high enough above the current share price to warrant purchase.

Each of these utilities comes with different expected sources of return. Transaction utility is all about getting a deal. Investors targeting this type of satisfaction attempt to buy stocks at a big discount to intrinsic value, or with a "margin of safety," as Ben Graham termed it. When the gap between purchase price and intrinsic value closes, positive returns will be earned.

Investors targeting acquisition utility, on the other hand, rely on long-term value growth to generate returns. The size of the current discount is less important, but it is critical that the intrinsic value grows significantly over the long term. The investment value will then grow along with intrinsic value, and positive returns will be generated.

> Transaction utility is all about getting a deal.

Which Utility to Target?

We have two types of utility to target, each offering a different source of returns. They also offer different risks. To illustrate, let's turn our attention back to the pervasive investment errors.

The first two persistent value investment mistakes occur when investors confuse which utility they are targeting. The first mistake, the error of omission – failing to buy a great company's stock when it is swooning, only to watch it rebound and grow its value

for many years thereafter – is made by targeting transaction utility when acquisition utility is more appropriate. Holding out for a huge discount to intrinsic value is counterproductive if the company truly is a great one that will continue to grow intrinsic value over the long term. Being a little less price conscious and buying the stock, to own it, will prove to be the right decision when the stock goes on to grow value for many years.

And the second error, the round trip – failing to sell an investment when it reaches intrinsic value, only to ride it back down again – is made by targeting acquisition utility when transaction utility is the appropriate aim. Again, an investor properly targeting transaction utility should have classified this stock as one bought to be sold when its price is no longer a deal, rather than one to be owned. Because its intrinsic value is not likely to grow at a fast clip for many years, it should be sold when it approaches intrinsic value.

We can reduce the chances of confusing which utility we are targeting by selecting only one type to target. Ben Graham and Warren Buffett did just that.

Ben Graham, the father of value investing and teacher of Warren Buffett, explicitly targeted transaction utility. His approach, which some call "deep value investing," aims to uncover statistically cheap stocks selling for "50 cents on the dollar," buy them, and sell them when they approach his estimate of intrinsic value. By sticking to the sell part of the discipline, he minimized the chances of committing the second pervasive error, the round trip.

Buffett, too, started his career following his teacher's defensible approach. But with the help of eventual partner Charlie Munger, Buffett noticed a persistent challenge. Buying a stock with the intent to sell meant you had to be right three times, not just with the original buy. You also had to be right with the sell decision, as well as the next buy decision as you eventually reinvest the sale proceeds. In Buffett's and Munger's eyes, this meant that there were three chances of making a mistake. So, Buffett evolved.

In the second half of Buffett's career, he evolved to explicitly target acquisition utility. In the vast majority of cases, he now buys stocks (and whole companies) with the intent to own them. Forever. By explicitly targeting acquisition utility, Buffett is less inclined to commit an error of omission – to miss a buying opportunity because he is holding out for a little lower price.

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How to Minimize the Three Pervasive Errors

So we have two defensible value investing approaches, each targeting a different type of utility. And we can minimize the risk of investment mistakes caused by confusing which utility we are after if we select only one to target. This is what Ben Graham did and Warren Buffett does. It is the simplest way to frame a value investment approach, and helps to reduce errors made by confusing which utility to target.

But we still need help in determining which investments are suitable for each of these approaches. And some investors would like to maintain the option to target both types of utility, thus increasing their investment flexibility. It turns out that both of these issues can be overcome if we frame the problem by answering two questions. For each company being considered as a potential investment, ask:

1. Can the company maintain its intrinsic value well into the future? If the research conclusion is that it can, then the company is a potential investment candidate to target transaction utility. Investors must then be patient and wait for enough margin of safety to emerge, thus signaling an appropriate investment opportunity. Price is critical. A deal is what they are after.

2. Can the company instead be expected to grow its intrinsic value at positive rates well into the future? This is a much higher bar to hurdle, as these types of long-term growth companies are rare. The business must have a secure and persistent base of profitability along with a long runway of profitable reinvestment opportunities. If research uncovers a candidate, investors can then wait for a buying opportunity to target acquisition utility. They can be less price conscious with these investments, but must be sure about the long-term value growth.

All other companies that don't meet either of these two screens (the far larger data set) must be discarded as potential investment opportunities. The insistence on only investing in companies that can at least maintain intrinsic value will reduce the chances of falling into value traps – investing in cheap stocks that remain cheap or get cheaper because their intrinsic value falls after investment. Framing the investment problem this way aids in minimizing that third pervasive value investing error.

A Framework to Minimize Mistakes

We identified three pervasive value investing errors – the error of omission, the round trip and the value trap. We then used Richard Thaler's classification of two types of utility to develop a framework to help minimize these mistakes:

1. Classify all prospective investments by determining which companies can at least maintain intrinsic value. By eliminating all others from being potential investment opportunities, the probability of investing in value traps is reduced. The resultant companies are suitable as potential targets for those targeting transaction utility when the discount from intrinsic value is large enough.
2. Companies that can clear a far higher bar, that have a near certain likelihood of significantly growing their long-term intrinsic value, are suitable as potential investments for those targeting acquisition utility. While investors can be less price conscious when making investment purchases with these companies, extreme care must be taken when coming to the conclusion about positive long-term value growth.
3. Having decided which of transaction or acquisition utility will be primarily targeted, monitor the portfolio companies. When the risk of a company having a different intrinsic value outlook than was originally determined has increased, action should be taken. If those companies that investors originally determined would maintain intrinsic value now look to be at risk of not doing so, the investment should be sold. The same is true for those companies they felt would generate long-term value growth when it no longer looks to be the case. This will prevent value traps from emerging within a portfolio.

Conclusion

Long-term investors are targeting more usefulness, or satisfaction, in their quest for better long-term returns. Economists call this satisfaction utility. Richard Thaler's identification of two types of utility – acquisition utility and transaction utility – allows us to develop a framework to help minimize the three pervasive errors value investors make. With this framework, some patience and a long time horizon, here's hoping we see fewer errors of omission, round trips and value traps – in short, less investor misbehaving – and a lot more portfolio satisfaction.

This issue of The View from Burgundy
was written by David Vanderwood,
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Endnotes

[i] Thaler, Richard H., *Misbehaving: The Making of Behavioral Economics*. New York: W.W. Norton & Company, 2015.

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