Adviser Industry Insights
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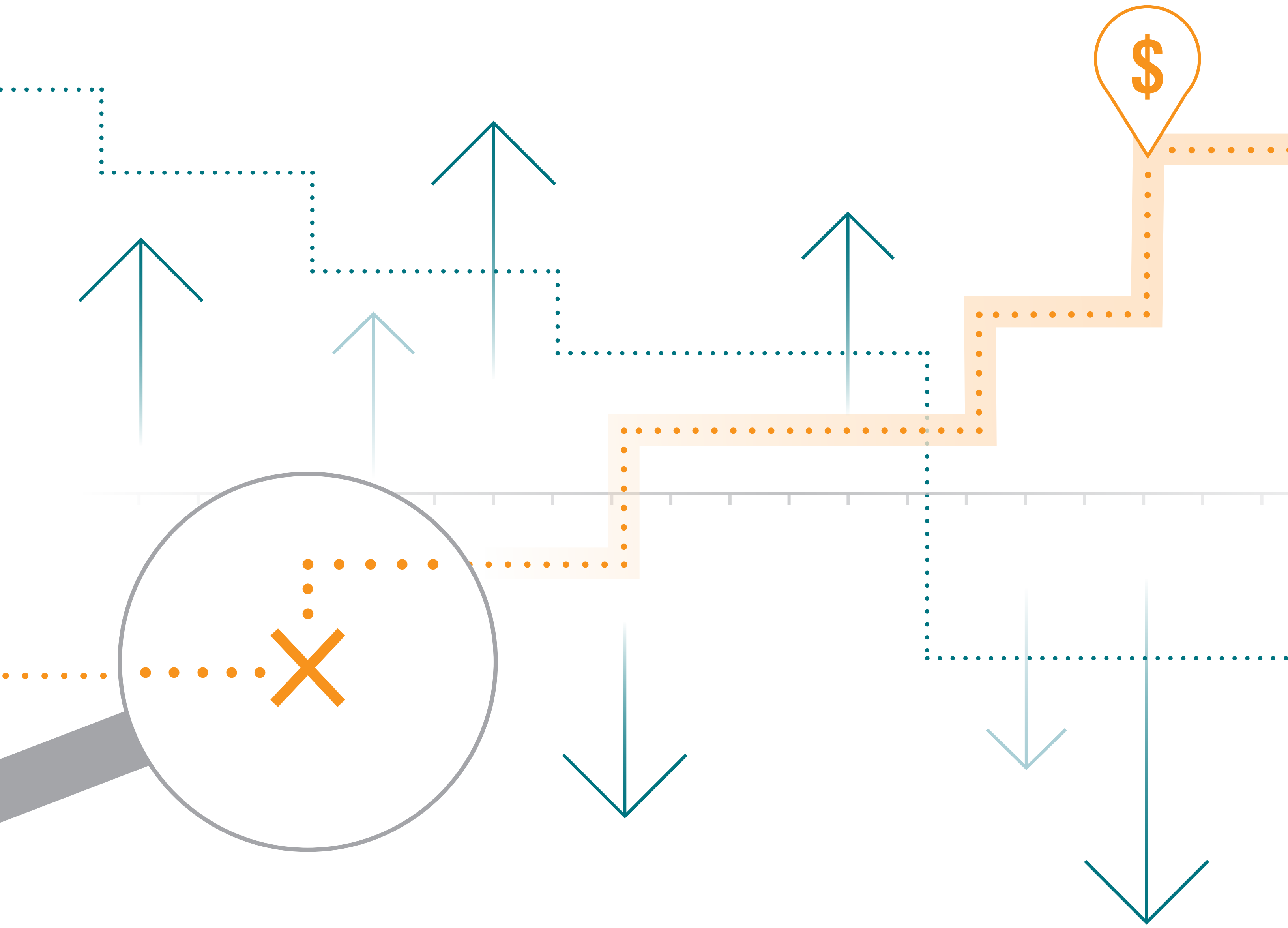
A Guide to Using Valuation-Driven Investing to Help Your Clients



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What You'll Learn

- The fundamentals of valuation-driven investing
- What it means to estimate the fair value of investments
- How valuation-driven strategies can help strengthen diversification

The purpose of investing is simple: to help investors reach their financial goals. Normally, you work to achieve this for your clients by maximizing the return on the capital the client has available, without taking excessive risk. The challenge for investors and their advisers today is how to achieve this in a market environment where prospective returns can be low.

Low rates and high risk

Today, interest rates and bond yields are at record low levels, mainly due to accommodative monetary policy. Investors do not have an alternative, as equities are generally at high valuation levels, especially in the U.S. Growth remains muted and macroeconomic risks are high. While markets have performed strongly in recent years, we cannot assume these returns will continue.

The temptation for investors is to either invest in more-speculative assets or to follow approaches that attempt to earn higher returns by short-term decisions driven by market timing. Neither of these are a reliable solution to the problem and both come with significant risks.

Price versus value

Instead, a more sensible approach is to focus solely on those assets that are currently priced significantly below their real value and avoid those that are priced above. This is known as valuation-driven investing. It is an approach that has been practiced by some of the world's best investors and identified by academics as a potential source of more consistent returns.

How valuation-driven investing works

Valuation-driven investing is built on two key concepts. First, an asset has a fair value that can be estimated through careful analysis. Second, while the price of an asset may deviate significantly from fair value in the short term, it will tend to return to its fair value over the long term.

Valuation-driven investors aim to earn superior returns by seeking out assets that are underpriced by the wider market and waiting for them to return to fair value. This approach may sound simple, but it can be extremely difficult to execute.

Concept 1: Estimating the fair value

The valuation-driven investment process requires you to estimate the fair value of the asset. Without a realistic assessment of the fair value, it is impossible to determine when the current price makes an investment an attractive opportunity.

What exactly is the fair value?

To do this, we must first be clear about what is meant by the **fair value** or **intrinsic value** of an asset. Benjamin Graham, who is considered the father of value investing, first defined it in his 1949 book *The Intelligent Investor*. It was later adopted by Graham's best-known student, Warren Buffett, who described intrinsic value as the "discounted value of future cash flows".

In other words, an asset is worth the sum total of the cash an investor expects to receive from owning it over its remaining life. Those cash flows must be discounted back to the present day at an appropriate rate to reflect the risks associated with those cash flows and the fact that money received in the future is typically less valuable, due to the effects of inflation. This becomes the **discount rate**, or the rate of return that helps you determine the present value of future cash flows.

An example calculation

So for example, if we know that an investment will give us a single payment of $1,000 five years in the future and we use a discount rate of 5% per year, we can calculate that the fair value of this investment today is (1,000)/(1.05^5)=$783.53.

This is a very simple illustration of estimating fair value. In reality, an investment is likely to make several payments to investors over a period of time and there may be uncertainty over what those payments will be. With a bond, we usually know what cash flows we will receive and when, assuming the borrower does not default. With a stock, we may not have much certainty about how its dividends are likely to change in the future.

How do you determine the discount rate?
To calculate the fair value, you need to select the appropriate discount rate. An accurate assessment should take into account the likelihood of the full range of probable outcomes. For example, an investment with a high level of uncertainty about future cash flows should be valued using a higher discount rate than one with more-certain cash flows. Returning to our example calculation in this guide, you might use a discount rate of 9% instead of 5% if you were calculating the fair value for an investment with more-uncertain cash flows.

What's past is prologue
Valuation-driven investors often turn to history as a guide, using long-term average valuations as a proxy for fair value. They adjust these valuations where necessary to reflect their assessment of the riskiness of the investment.

Of course, there will always be questions over whether typical historic valuations are still a good reflection of what investors should expect today or whether "this time it's different." While these questions are valid, the fact that this phrase has been described as "the four most dangerous words in investing" by legendary value investor Sir John Templeton should act as a reminder that historical norms hold true more often than not. In the case of valuation-driven investing, looking backward can be a way to help you determine fair values moving forward.

Concept 2: How to get (and potentially keep) more than what you pay

To use a valuation-driven investing process, you need to identify investments that seem to be trading at a substantial discount to their fair value. This may sound simple compared to the process of estimating fair value, but investors must always be alert to the risk of **value traps**. These are investments that appear to be cheap relative to their fair value, but their fair value estimate does not properly consider the deteriorating prospects of the underlying business. These investments are unlikely to return to their apparent fair value and if their outlook worsens, investors may even suffer permanent capital losses. But how can you tell the difference between a true bargain and a money pit?

There are two steps that can help you avoid value traps:

1. Conduct deep fundamental research on the business whenever the price of an asset appears to have become dislocated from its apparent fair value.
   Your goal for this research is to determine whether historic valuation norms still hold. Including this step in the investment process differentiates valuation-driven investment, which uses value as a starting point for further research, from simpler value-investing approaches that typically select investments using only basic comparative valuation metrics.

2. Ensure that the purchase price of an asset includes a significant margin of safety.
   The **margin of safety** is the difference between the intrinsic value of an investment and its market price. This concept, defined by Benjamin Graham and David Dodd in their 1934 book, *Security Analysis*, is based on the premise that it is usually impossible to calculate a precise fair value. Consequently, investors should focus only on assets that are currently priced at a substantial discount to the best estimate of fair value. The idea is this: If the discount is large enough, it is unlikely that the asset will represent a poor value, even if its fair value estimate is inaccurate.

   The margin of safety that an investor demands is not constant but will depend on the predictability of the fair value. For example, the margin of safety required by an investor to justify a long-term investment in a mining company will be significantly greater than the margin of safety needed to hold a short-term government bond, due to the relative uncertainty of calculating the future cash flows for the mining company stock.

Valuation and true diversification
Valuation-driven investment is typically associated with equities, yet is equally applicable to other assets. Valuation gaps against historical norms may occur in any sector, geography or asset class, including bonds and property. If an asset provides a cash flow that you can analyse, then you can make the calculations required to estimate its intrinsic value. We can strive to calculate an expected return for each asset class and then allocate capital across equities, bonds and property, as well as across geographies, to potentially generate the highest return for a given level of risk.

When diversification isn't enough
Multi-asset investing has traditionally depended on diversifying among assets that have low correlation with each other to reduce volatility and create a smoother investment journey. A simple approach to diversification may not always be effective in reducing the risk of permanent capital loss, however, as it is possible for the majority of assets to be overvalued at the same time. Also, valuation anomalies tend to be driven by investor sentiment, so it's possible for investments in different asset classes to be affected by the same economic developments.

For example, concerns about a slowdown in Chinese economic growth could affect assets as diverse as commodities, emerging-markets bonds and European luxury goods manufacturers. So investors who are building a valuation-driven portfolio must take account of the underlying drivers of returns and hold assets that are diversified among these drivers, rather than those that simply have low historic correlation.

Keeping your strategies productive
A valuation-driven investment strategy excludes assets that are not productive, such as gold, which generates no returns and is priced purely based on market speculations. The justification for including nonproductive assets in a portfolio rests entirely on the fact that they often have low correlation with assets such as stocks and bonds, creating short-term diversification benefits within a portfolio. Holding uncorrelated, nonproductive assets may reduce the severity of short-term declines, but this will typically come at some cost to long-term performance.

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Our managed portfolio services can help enhance your investment offerings, strengthen client relationships and streamline your business. Together, we strive to bring your clients the best of both worlds: A plan you've tailored to their goals with many of the advantages of professional portfolio management.

Recommended Reading

Ben Graham's 1949 book, *The Intelligent Investor*, is the foundation of the valuation-driven investing approach. It can be a bit intimidating, but Graham's light humor helps carry the reader through.

If you are intrigued and would like to learn more about valuation-driven investing, we suggest:

The Most Important Thing
Howard Marks

Margin of Safety
Seth Klarman

The Warren Buffett Way/The Warren Buffett Portfolio
Robert Hagstrom

Value Investing
James Montier

The Little Book of Common Sense Investing
John C. Bogle

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Call **+ 1 877 626–3227**
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