3 Challenges and 7 Tips for Valuation-Driven Investing
At its core, investing is simple: select a diversified portfolio of assets with the appropriate level of risk and continue to hold over your investment period, rebalancing if necessary to maintain your desired mix of holdings.

One way to potentially improve this is to invest in assets that have an unusually attractive expected return compared to the risk of permanent capital loss. As the future is uncertain, luck plays a role in determining returns, as does behavior, especially over the short term.

Speaking of behavior, all seasoned investors have witnessed periods of excessive fear and greed. Recessions are scary, as are wars and financial crises. On the other side, the good times often feel great, with people seemingly making money hand over fist. Fear and greed will be ever-present among market participants, sometimes creating the opportunity to sit on the other side of the trade — to be fearful when others are greedy, as Warren Buffett eloquently put it. With the right process, this creates the opportunity to tilt the probability of success in your favor. If repeated consistently and with discipline, the idea is that you could deliver long-term returns.

**Reliable Approach Option**

While everyone’s path will be different, one approach is to seek enhanced risk-adjusted returns. This is known as valuation-driven investing and has been considered by investors for most of the last century. This approach prioritizes investing in assets that are currently priced at a discount to their ‘fair’ value. Or, in relative terms, the approach seeks to identify assets that are trading more cheaply than assets with similar characteristics.

While such an approach may sound straightforward, it is challenging to apply in practice. We have therefore created this guide to help you understand the challenges and how they may be overcome through the application of a well-structured and disciplined process organized into seven insights.
3 Challenges for Valuation-Driven Investing

1. Self-Awareness of Fear and Greed
   The first challenge for investors seeking to adopt a valuation-driven approach is behavioral. Opportunities are often created by predictable weaknesses in the human ability to make rational decisions when faced with the uncertainty that characterizes all investments. These weaknesses usually surface on the pendulum between fear and greed and continue to overwhelm investors today. To overcome this challenge, it is necessary to accept that the future is both uncertain and irreducibly complex. We must therefore approach it probabilistically, considering a range of potential outcomes rather than fixing on a single result. This tends to be uncomfortable for all investors who naturally seek certainty when faced with risk.

2. Are You Willing to be Different?
   An additional challenge is that our incentives often vary from the simple maximization of long-term returns. In some circumstances, we may make a decision that is rational given our incentives but it is nevertheless poorly correlated with the potential for investment success. For example, we may be drawn to buy an asset because everyone else is enthusiastic about it. As social creatures, we have a strong incentive to join that group by investing the same way, despite that investment having a low expected return. Such patterns of behavior are common in both individual and professional investors and was best summarized by John Maynard Keynes, who said: “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.”—The General Theory of Employment, Interest, and Money.

3. Markets are Only Inefficient at Extremes
   A third challenge is that assets are normally priced near their fair value or in line with comparators. Consequently, valuation-driven investors do not have a consistent set of attractive opportunities. When opportunities do emerge, they are typically priced cheaply because other investors believe them to be flawed and, as a result, tend to be unpopular or controversial. The revulsion these assets provoke can create considerable momentum, leading to prices moving further below their fair value. Consequently, a valuation-driven approach cannot help investors or portfolio managers predict short-term returns or avoid short-term losses. It is intended solely as a strategy that strives to deliver long-term returns.
7 Tips for Valuation-Driven Investing

1. Find the Right Opportunities
This requires a consistent valuation framework for estimating the fair value of an asset and a systematic search process. Many of the greatest value opportunities lie in unglamorous industries, niche markets, or companies that have recently experienced bad news but remain fundamentally strong. A systematic screening process can help you overcome the market noise and expectations driven by recent price movements.

2. Do the Fundamental Research
As the fair value of an asset is determined by its future cashflows, fundamental analysis must combine a deep understanding of the drivers of that cashflow—as well as any associated risks (appreciating what could go wrong) and the subsequent probability of potential outcomes. Examining the current price, the investor is able to use the results of this analysis to estimate the attractiveness of the asset relative to other opportunities.

3. Play the Long Game
Valuation is seldom an indication of near-term market movements. Underpriced assets are often so disliked by other investors that it can take years for them to be appreciated. However, the change in price associated with their rehabilitation can be so considerable that the wait is worthwhile. Buying an undervalued asset is therefore only the beginning of the investment journey—patience is essential.

4. Stay Mentally Tough
The separation of the fair value of an asset and its price can lead us to learn the wrong lessons when investing. For instance, the price of an asset we hold may rise for reasons that are completely different from our expectations, and yet we feel good about our decisions. Successful investors ignore the feedback of short-term price changes and focus instead on comparing the progression of the cashflow to their expectations.

This focus on the process rather than the outcomes will help give you the confidence to stick with your decisions, as well as the willingness to change them when circumstances change and an asset no longer appears attractive.

5. Think in Base Rates, Not Stories
As humans, we are naturally drawn to familiar narratives. Often these narratives describe the extraordinary rather than the ordinary. This can lead us to unrealistic expectations when we attach a narrative to a potential investment. However, most situations are necessarily ordinary and so it is worth testing our expectations against an ordinary outcome. We call these ordinary expectations base rates, and they are a useful way of remaining grounded as we think about the future.
6. Avoid Trading Too Much
Trading not only increases the cost of investment, it can be a sign that the investor is expressing overconfidence in their ability to predict short-term market movements. While some trading is essential to good portfolio management (for rebalancing), and other forms of trading can be supportive of returns (such as tax loss harvesting), all changes must be made with a long-term perspective.

7. Build a Robust Portfolio
A portfolio that depends too heavily on a single factor to drive returns effectively becomes a forecast of that factor. For example, returns for a portfolio concentrated in oil stocks will be too dependent on oil prices. Such factors are often very difficult or impossible to forecast accurately. Therefore, investors should think carefully about robustness, aiming to diversify their portfolio among different holdings and size them in such a way that returns will be driven by a range of unrelated factors.

About Risk and Volatility (There’s a Difference)
All investment involves a degree of risk—without risk, there would be no additional return. Rational investors accept as little risk as possible in the investments they’re making to reach their financial goals. Yet investors define risk in different and sometimes contradictory ways. Valuation-driven investors often define risk as a permanent loss of capital. An example of risk would be lending money to a borrower who only pays back 50% of the loan.

The Origins of Volatility
While this definition of risk may appear intuitive, it is very different from the concept of volatility, which happens to be a common definition of risk used by many professional investors. Volatility describes the periodic variations in the price of an asset. While volatility may be related to changes in the fair value of an asset, it often represents variations in market sentiment. Investors tend to react to bad news more extremely than good news, so high levels of volatility are associated with falling prices. When volatility is low, prices are typically rising gradually.

When to Look for Bargains
For the valuation-driven investor, periods of high volatility represent opportunities to buy assets at prices below their fair value. At the same time, bargains become scarce during periods of low volatility, when valuation-driven investors tend to take a buying break. In contrast, investors who use volatility as a proxy for risk shun bargains in volatile markets and enthusiastically purchase overpriced assets when volatility is low, potentially eating into their returns as a result.

The Madness of the Crowd
The crowd mentality that sometimes takes over the investment community during periods of volatility can drive prices to extreme levels of overvaluation or undervaluation. This in turn can lead to periods of severe underperformance by fund managers and other investors.

The Lonely Contrarians
Few investment firms are prepared to tolerate prolonged periods of underperformance. As a result, many fund managers have powerful incentives to follow the crowd in an effort to deliver short-term returns that are similar to the rest of the pack. This phenomenon was powerfully demonstrated during the dot-com boom at the beginning of the century, when investors who rejected overpriced stocks were pilloried by their peers, abandoned by investors, and in some cases lost their jobs. Shortly after, the market’s correction proved them right.
Our Approach and Investment Principles

The greatest challenge to valuation-driven investment is not the difficulties of estimating the fair value of an asset or of avoiding value traps, but in overcoming the behavioral biases that affect all investors to some extent. These biases were first highlighted by John Maynard Keynes in the 1930s but were fully identified by the pioneering work of Amos Tversky and Daniel Kahneman in the 1970s. Biases can cause investors to act irrationally when faced with solving the complex problems associated with investment, leading them to make bad decisions and experience poor performance.

Bad News and Bear Markets
There are many examples of these biases, but one of the most pernicious is the availability bias, which encourages us to regard recent information as more valuable than older perspectives. This error, when coupled with the aversion to loss that most people suffer, partially explains why cheap assets can become cheaper. Investors tend to remember the bad news that caused the fall in price more vividly than previous good news. They also prefer avoiding losses over experiencing gains. As a result of these combined behaviors, investors sell the asset or avoid buying it at the very time they should be considering it.

How We Do It
Morningstar’s Investment Management group follows a series of seven investment principles that help our portfolio managers focus on the long term and remain steadfast in their behavior. These principles reflect both the findings of academics and our 30+ years of experience analyzing fund managers. Our principles are designed to counteract the pressures felt by all valuation-driven investors.

Our Principles

- We Put Investors First
- We’re Independent-minded
- We Invest for the Long Term
- We’re Valuation-driven Investors
- We Take a Fundamental Approach
- We Strive to Minimize Costs
- We Build Portfolios Holistically
Valuation-driven investment is most commonly used to select individual securities, but it can also be applied when building multi-asset portfolios. Traditional strategic asset allocation involves assigning relatively static allocations to each asset class and offers little flexibility when market conditions change. Valuation-driven asset allocation, in contrast, allows for total flexibility.

Our principles empower our portfolio managers to seek any excess returns that are available by consistently applying the valuation-driven approach throughout all types of market conditions.

We regularly publish research and guides on valuation-driven investing. Our investment management offerings can also help enhance your investment offerings, strengthen client relationships, and streamline your business. Together, we aim to bring your clients the best of both worlds: a plan you’ve tailored to their goals and professional portfolio management.
About Morningstar’s Investment Management

Drawing on our core capabilities in asset allocation, investment selection, and portfolio construction, Morningstar’s Investment Management group provides a global point of view and local market experience. Our investment professionals, located around the world, are guided by core principles focused on long-term investment results and helping end investors reach their financial goals. Built around investment strategies and harnessing the global resources of Morningstar, Inc., our investment offerings support financial advisors, institutions, and the investors they serve. Morningstar® Managed Portfolios™ provides professional guidance and access to strategies that can help investors reach their financial goals.

Want more literature on valuation-driven investing?

Contact Your Local Sales Representative

📞 +1 877 626-3227
✉️ mp@morningstar.com
🔗 mp.morningstar.com