

Authors Google

Tobias Carlisle
Deep Value

November 20th, 2014

Tobias E. Carlisle

Managing Director
Eyquem Investment Management LLC

Portfolio Manager
Eyquem Fund LP

Author

Deep Value (Wiley 2014)

Quantitative Value (Wiley 2012)

www.greenbackd.com

www.acquirersmultiple.com



Four Parts

1. A Deep Value Manifesto
2. Contrarians at the Gate
3. Simple But Not Easy
4. The Acquirer's Multiple



Part 1. A Deep Value Manifesto

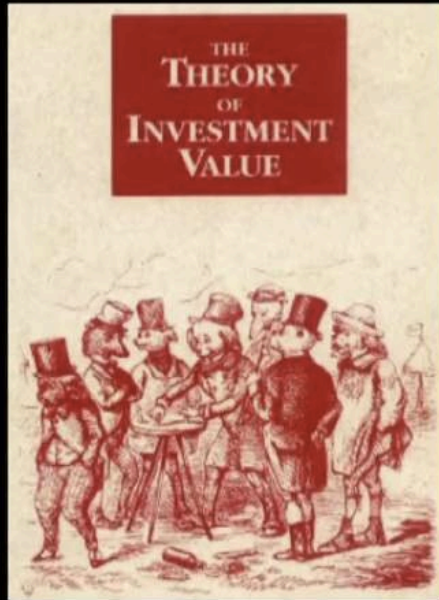


“Corporate gold dollars are now available at 50 cents or less—but they do have strings attached.”

— *Benjamin Graham* (1932)



Theory of Investment Value



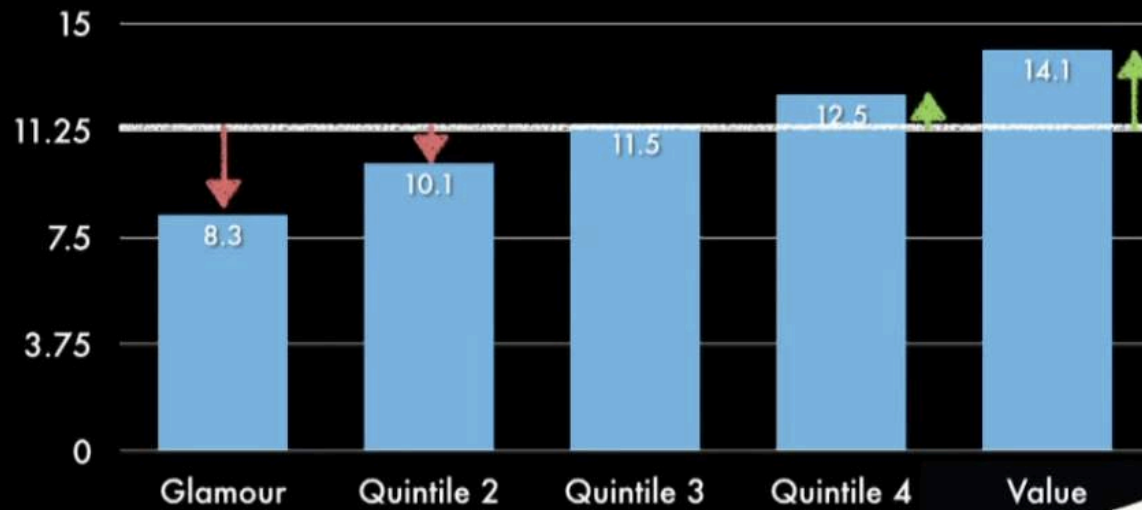
“The value of any stock, bond, or business today is determined by the **cash inflows and outflows**—**discounted** at the appropriate rate—that can be expected to occur during the remaining life of the asset.”

—*Buffett* quoting **John Burr Williams** (1938)



Value > Glamour

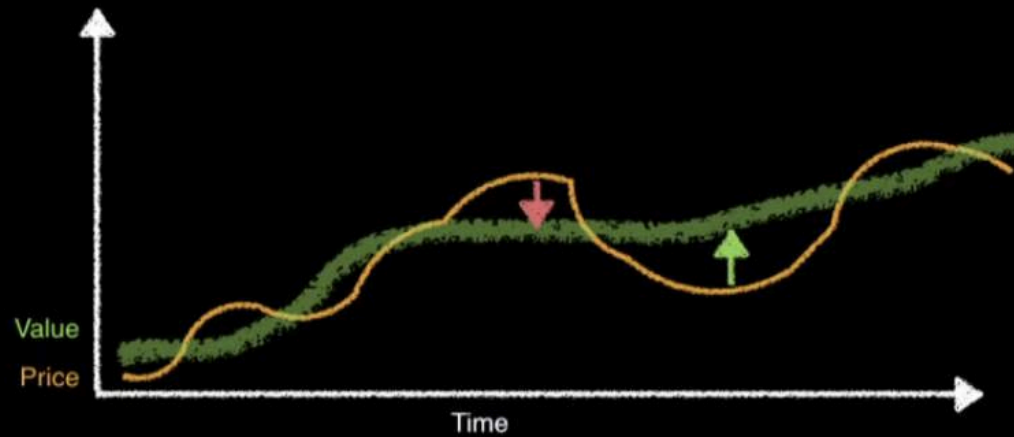
Global Markets Average Yearly Returns to
Portfolios Sorted by PE, PB, and PCF (1980 to 2013)



Source: Eyquem Investment Management LLC



Price:Value



“Prices fluctuate more than values
—so therein lies opportunity.”

—Joel Greenblatt



Mean-Reverting Mystery



“When you find a special situation and you decide that you can buy for 10 and it is worth 30, and 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?”

— *Senate Committee Chair (1955)*



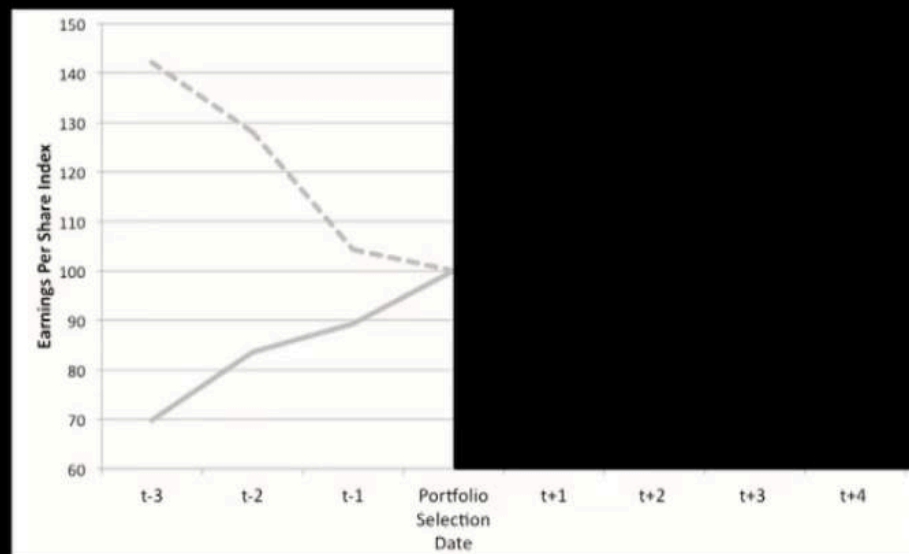
Favorable Outcomes

1. Creation of an earning power commensurate with the company's assets. This may result from:
 - a. **General improvement in the industry**
 - b. **Favorable change in the company's operating policies**, with or without a change in management
2. A sale or merger
3. Complete or partial liquidation

—Graham and Dodd (1934)



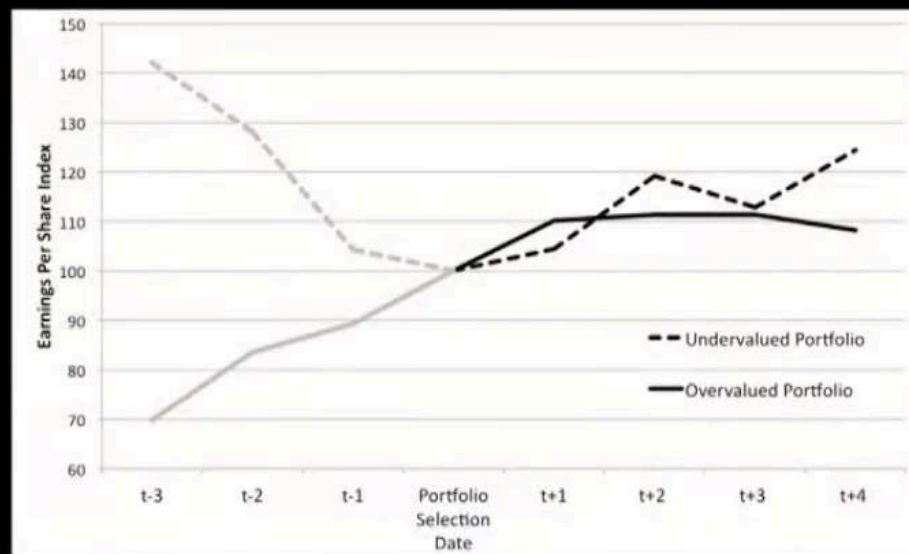
Part 2: Contrarians at the Gate



Source: DeBondt and Thaler (1987) "Investor Overreaction"



Part 2: Contrarians at the Gate



Source: DeBondt and Thaler (1987) "Investor Overreaction"



Catch a Falling Knife

Growth and Valuation of PE and Sales Growth Portfolios (1963 to 1990)

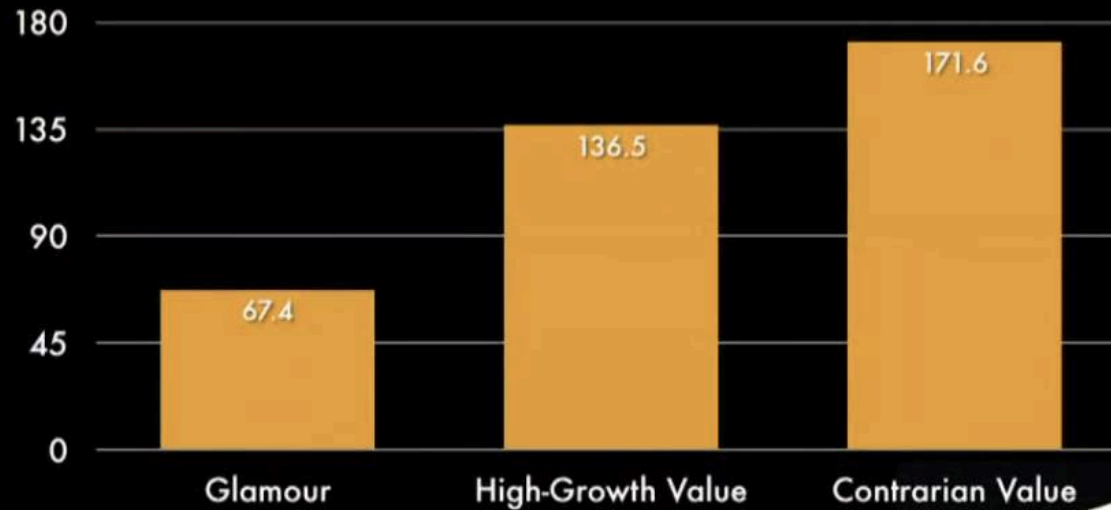
| | Glamour | High-Growth Value | Contrarian Value |
|---------------------------|---------------|-------------------|------------------|
| Earnings | 18.7% / 19.6X | 16.9% / 6.3X | 9.7% / 6.5X |
| Cash Flow | 18.1% / 10.8X | 16.3% / 3.9X | 7.4% / 3.7X |
| Book Value | 15.2% / 0.7X | 13.9% / 0.3X | 2.5% / 0.2X |
| Operating Earnings | 18.2% / 6.3X | 16% / 2.2X | 5.9% / 2.3X |

Source: Lakonishok, Shleifer and Vishny "Contrarian Value" (1994)



Naive Extrapolation

Average 5-Year Returns to Portfolios Sorted by PE and Sales Growth (1974 to 2011)



Source: Lakonishok, Shleifer and Vishny "Contrarian Value" (1994)



Contrarian Value

Growth and Valuation of PE and Sales Growth Portfolios (1963 to 1990)

| | High-Growth Value | Contrarian Value |
|---------------------------|-------------------|------------------|
| Earnings | 16.9% / 6.3X | 9.7% / 6.5X |
| Cash Flow | 16.3% / 3.9X | 7.4% / 3.7X |
| Book Value | 13.9% / 0.3X | 2.5% / 0.2X |
| Operating Earnings | 16.0% / 2.2X | 5.9% / 2.3X |

Source: Lakonishok, Shleifer and Vishny "Contrarian Value" (1994)



In Search of Excellence

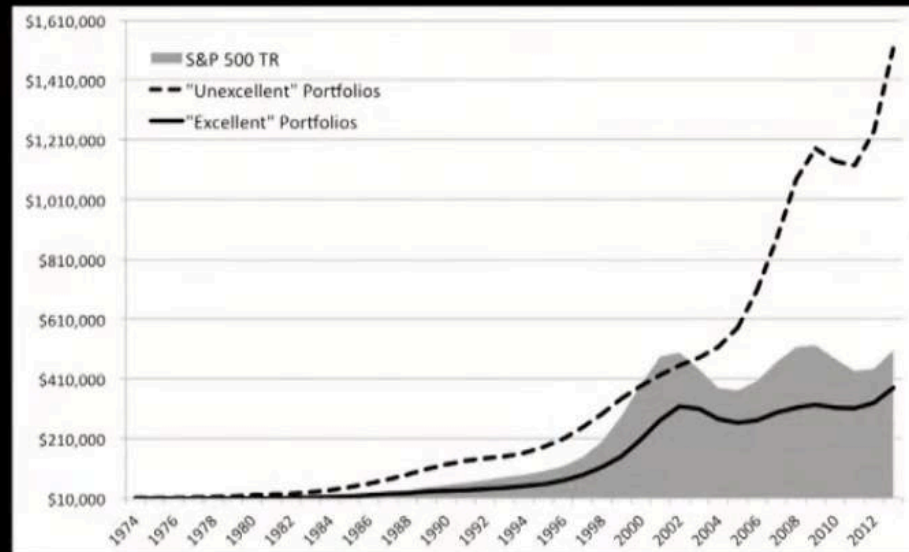
Average Five-Year Financial Characteristics (1976 to 1980)

| | Excellent | "Unexcellent" |
|---------------------|-----------|---------------|
| Asset Growth | 21.78% | 5.93% |
| Equity Growth | 18.43% | 3.76% |
| Price-to-Book Value | 2.46X | 0.62X |
| Return on Capital | 16.04% | 4.88% |
| Return on Equity | 19.05% | 7.09% |
| Return on Sales | 8.62% | 2.49% |

Source: Michelle Clayman "Contrarian Value" (1994)



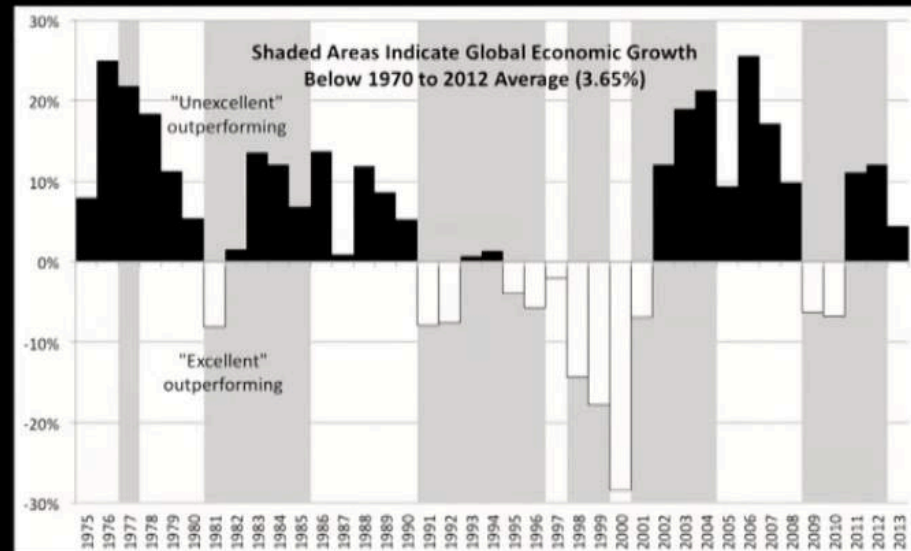
“Unexcellence” Prevails



Source: Deep Value via Barry Bannister, Stifel Financial (2013)



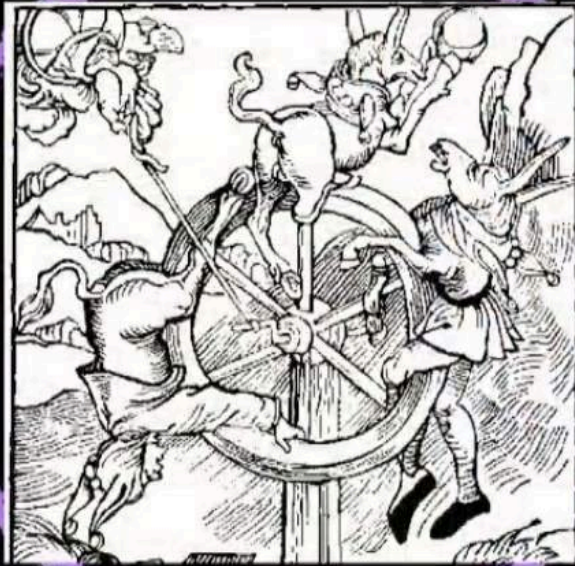
“Bad” States of the World



Source: Deep Value via Barry Bannister, Stifel Financial (2013)



The Wheel of Fortune

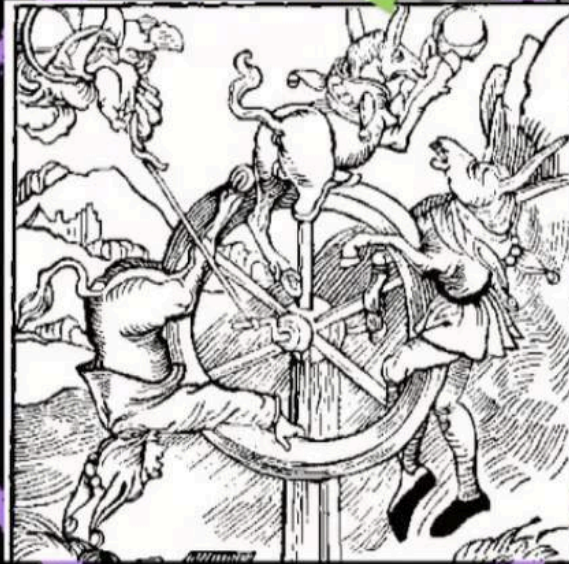


Albrecht Durer (1494)



The Wheel of Fortune

Regno
"I reign"



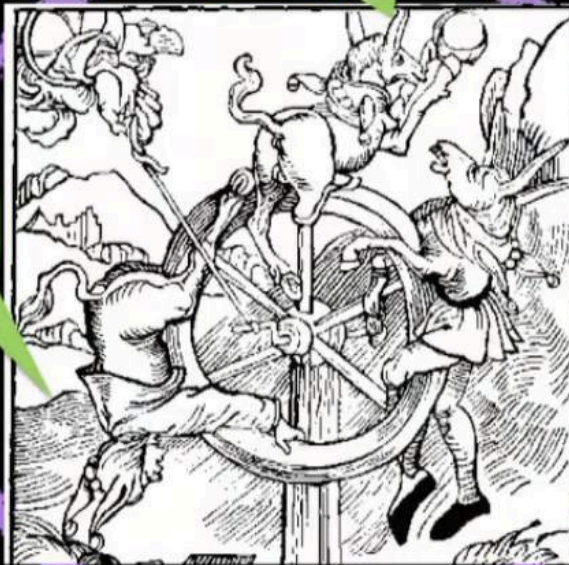
Albrecht Dürer (1494)



The Wheel of Fortune

Regno
"I reign"

Regnavi
"I reigned"



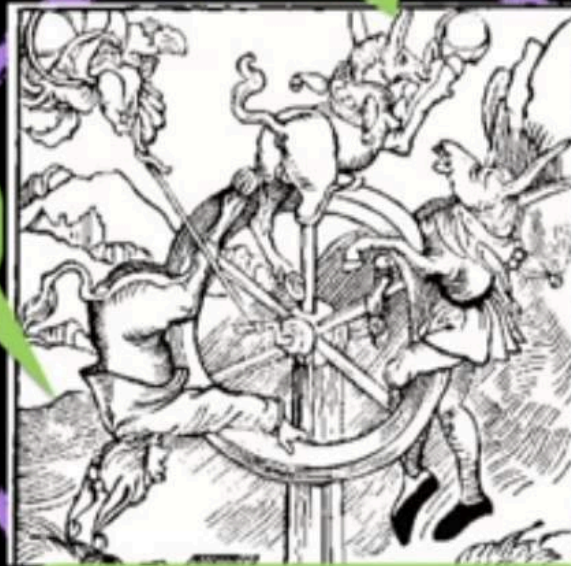
Albrecht Durer (1494)



The Wheel of Fortune

Regno
"I reign"

Regnavi
"I reigned"

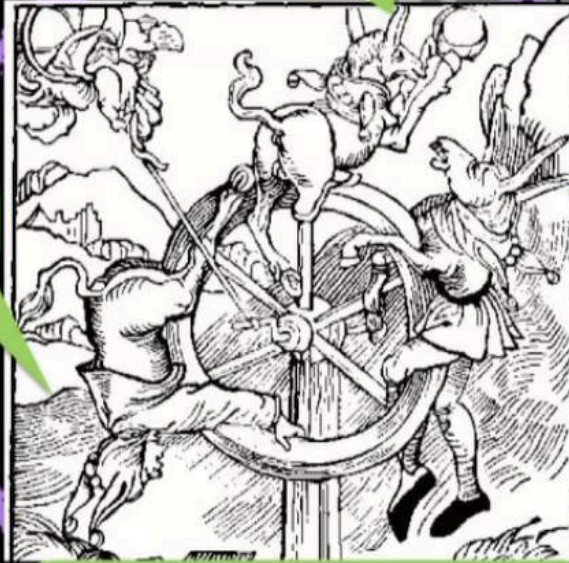


Sum sine regno
"I am without a kingdom"



The Wheel of Fortune

Regno
"I reign"



Regnavi
"I reigned"

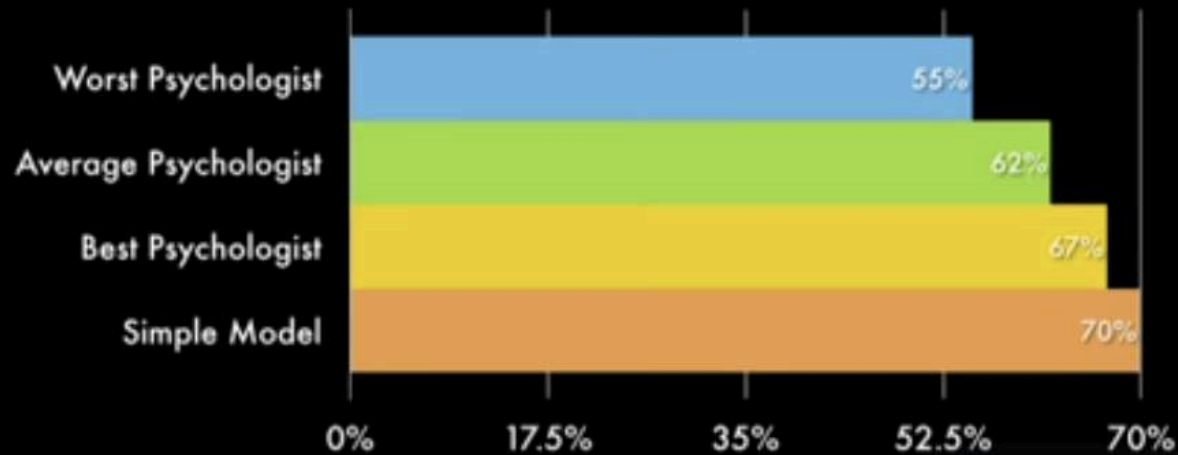
Regnabo
"I will reign"

Sum sine regno
"I am without a kingdom"



Part 3. Simple But Not Easy

Minnesota Multiphasic Personality Inventory (MMPI)
Hit Rate for Diagnosis

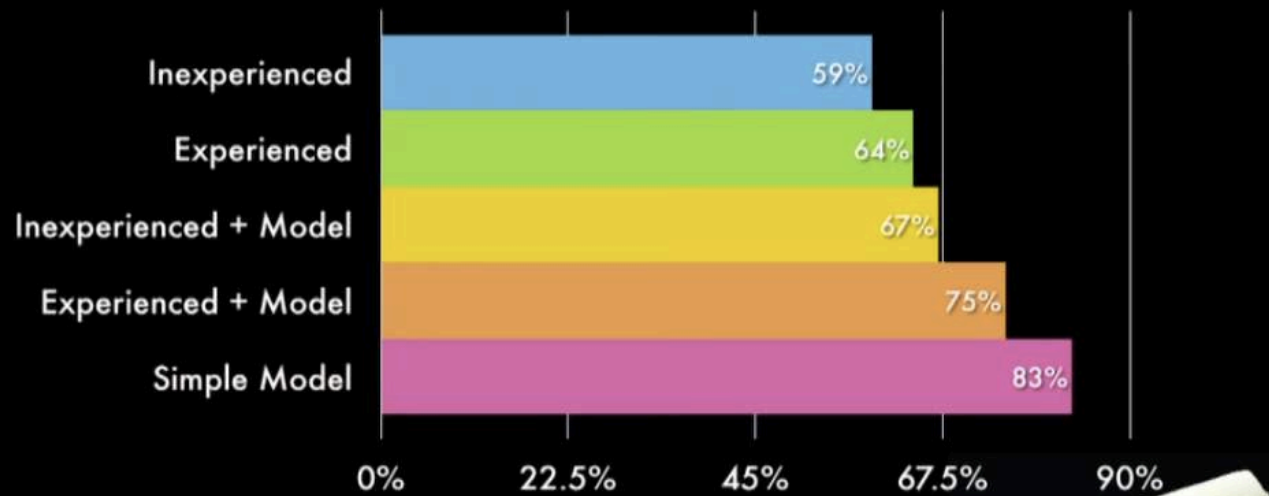


Source: Dresdner Kleinwort Macro Research (2006)



Experts + Simple Model

Minnesota Multiphasic Personality Inventory
(MMPI) Hit Rate for Diagnosis



Source: Dresdner Kleinwort Macro Research (2006)



The Magic Formula



Wonderful companies
at **fair prices**

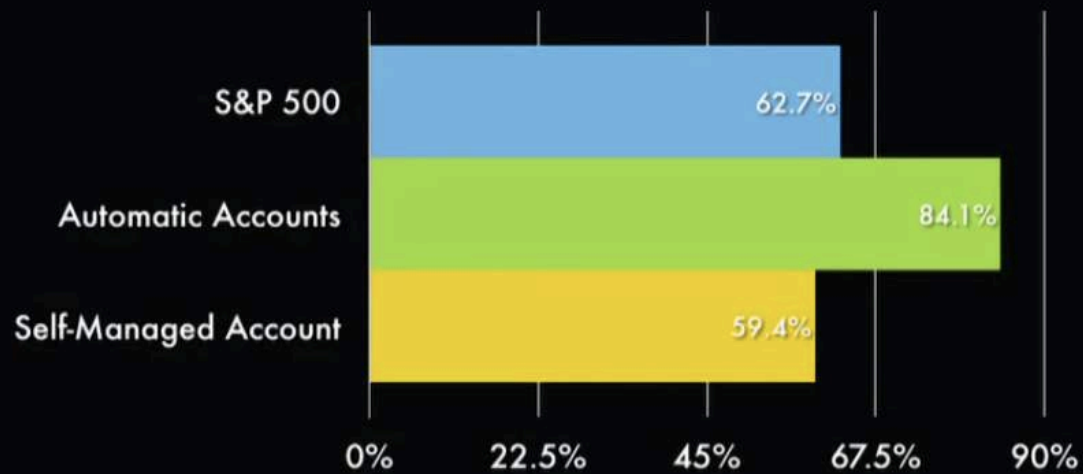
means

High quality and
good value



Broken Formula?

Cumulative Return SMA vs Automatic Accounts
May 2009 to April 2011



Source: Greenblatt (2011)



No Cherry Picking



“When we tried, we did not do a good job. And we’re pretty good analysts.”

—*Joel Greenblatt*



The Golden Rule



Simple models outperform experts
**even when experts have access
to the simple model's output**



80:20 Rule



“Most investors strive fruitlessly for certainty and precision...

High uncertainty is frequently accompanied by **low prices**”

—*Seth Klarman* (1991)



Net Current Asset Value

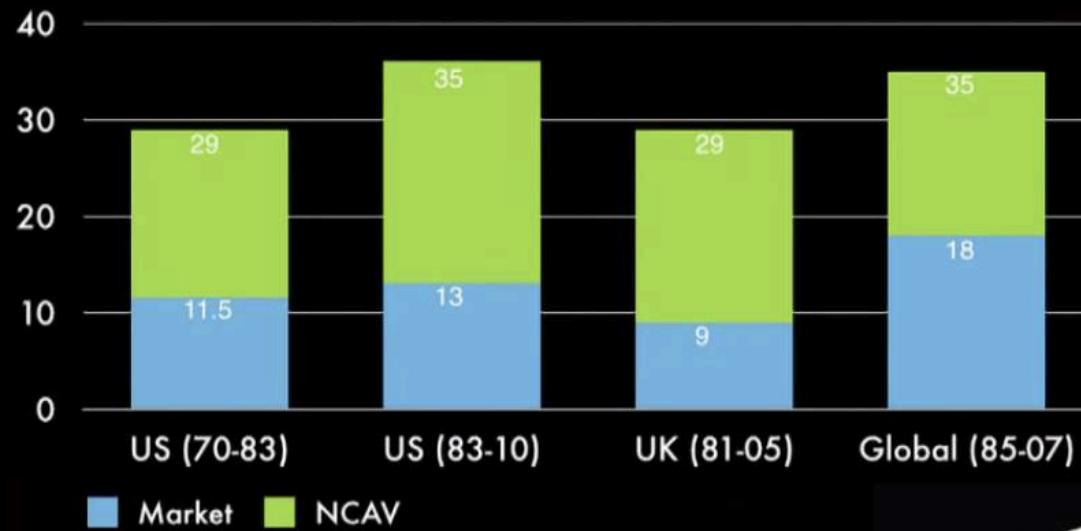
| Type of asset | % of liquidating value to book value | |
|---|--------------------------------------|------------------|
| | Normal range | Rough average |
| Current assets: | | |
| Cash assets (including securities at market)..... | 100 | 100 |
| Receivables (less usual reserves)*..... | 75-90 | 80 |
| Inventories (at lower of cost or market)..... | 50-75 | 66 $\frac{2}{3}$ |
| Fixed and miscellaneous assets: | | |
| (Real estate, buildings, machinery, equipment, nonmarketable investments, intangibles, etc.)..... | 1-50 | 15 (approx.) |

* NOTE: Retail installment accounts must be valued for liquidation at a lower rate. Range about 30 to 60 %. Average about 50 %.

“A rough measure of **liquidating value**”
 —Graham and Dodd (1934)



Net Nets Outperform



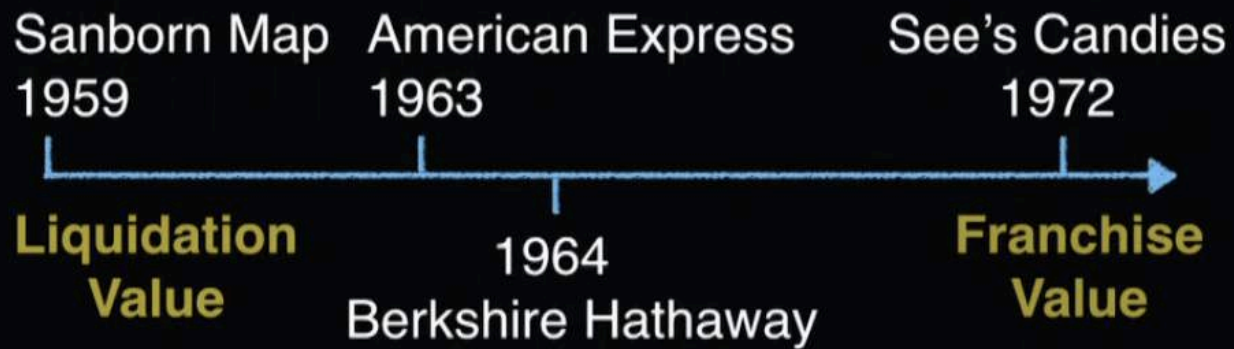
Counterintuitive Lessons



1. Fewer down years than the market
2. Loss-making net nets beat profitable net nets
3. Non-dividend paying net nets outperform dividend payers



Buffett: Liquidator to Operator



Lessons from See's Candies

Graham: Cigar Butts

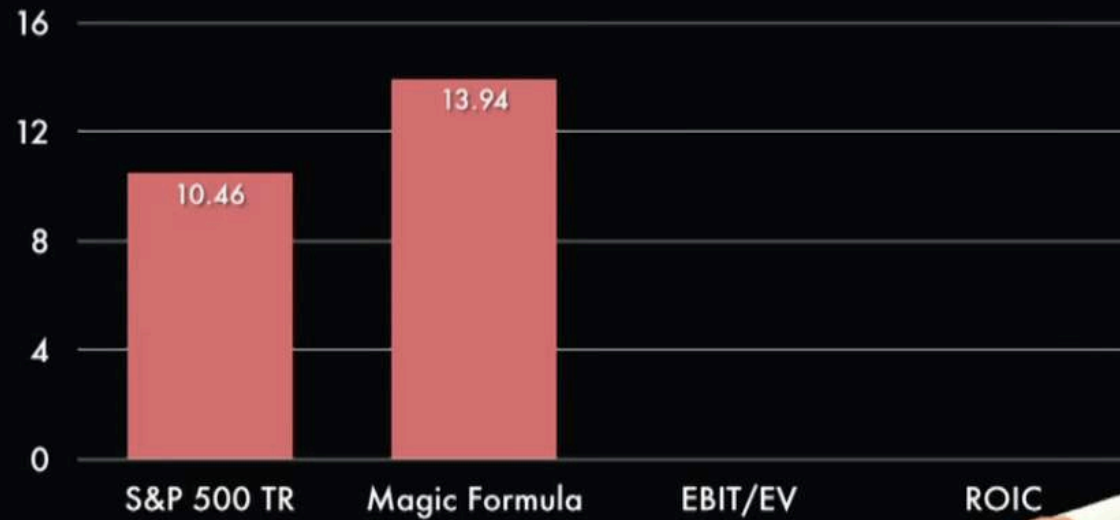


Buffett: Wonderful companies at fair prices



Value > Quality

Returns to the Magic Formula vs its Parts: EBIT/EV and ROIC (1974 to 2011)

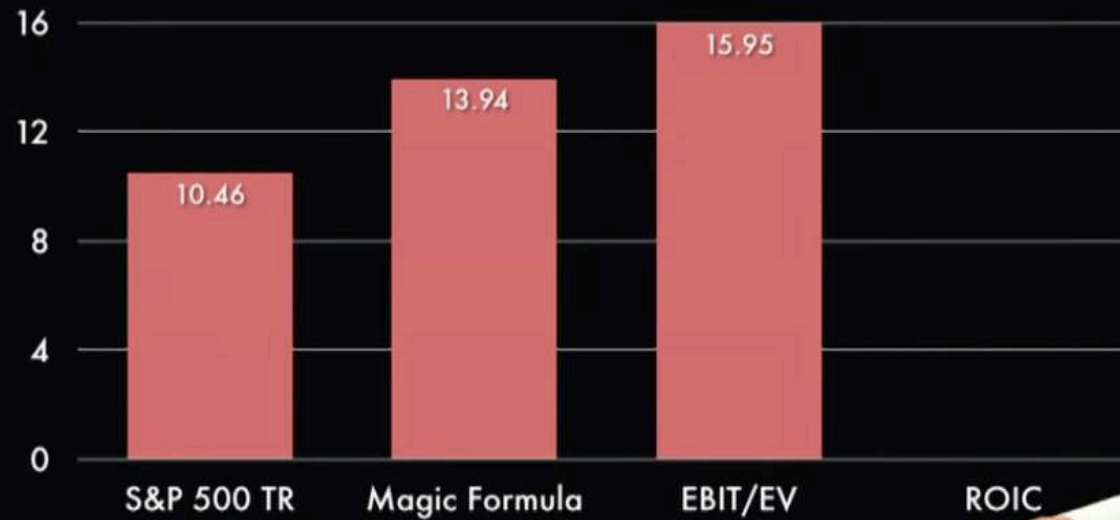


Source: Gray and Carlisle (2012)



Value > Quality

Returns to the Magic Formula vs its Parts: EBIT/EV and ROIC (1974 to 2011)

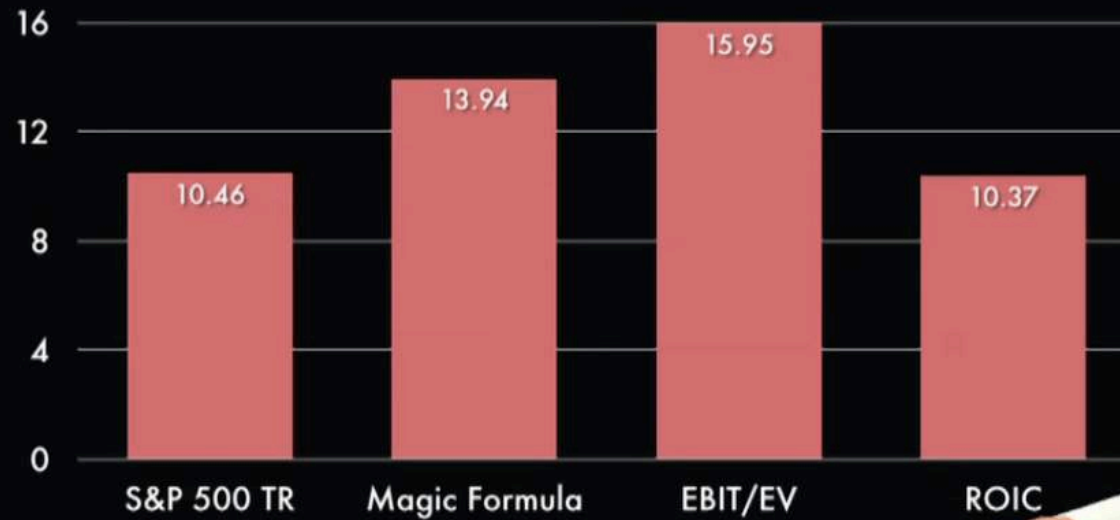


Source: Gray and Carlisle (2012)



Value > Quality

Returns to the Magic Formula vs its Parts: EBIT/EV and ROIC (1974 to 2011)



Source: Gray and Carlisle (2012)



Value > Quality

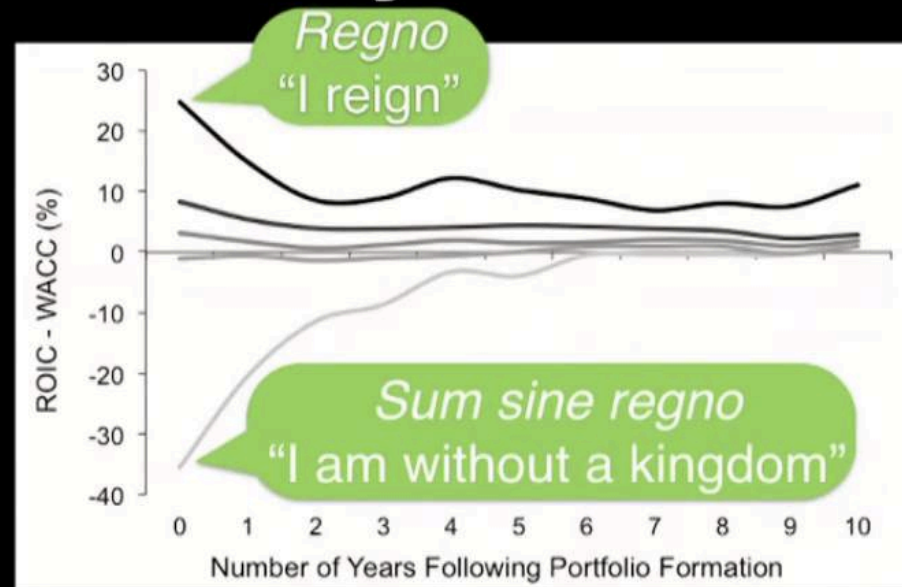
Statistics for the **Magic Formula** vs its Parts: **EBIT/EV** and **ROIC** (1974 to 2011)

| | S&P 500 TR | Magic Formula | EBIT/EV | ROIC |
|-------------------------------|-----------------------|----------------------|----------------|-------------|
| CAGR | 10.46% | 13.94% | 15.95% | 10.37% |
| Standard Deviation | 15.84% | 16.93% | 17.28% | 17.04% |
| Sharpe Ratio | 0.37 | 0.55 | 0.64 | 0.35 |
| Sortino Ratio (MAR=5%) | 0.56 | 0.80 | 0.96 | 0.56 |

Source: Gray and Carlisle (2012)



Quality and ROIC

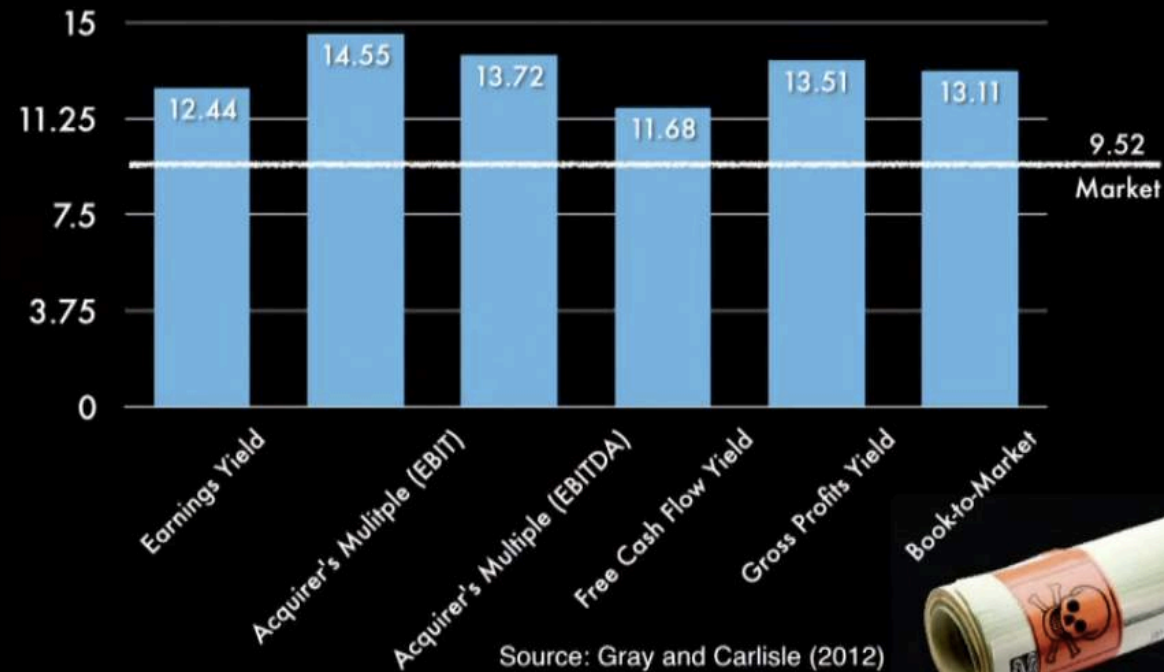


Source: Michael Mauboussin,
The Success Equation (2012)



Price/Value Ratio Test

Compound Annual Growth Rates for Price/Value Ratios VW (1964 to 2011)

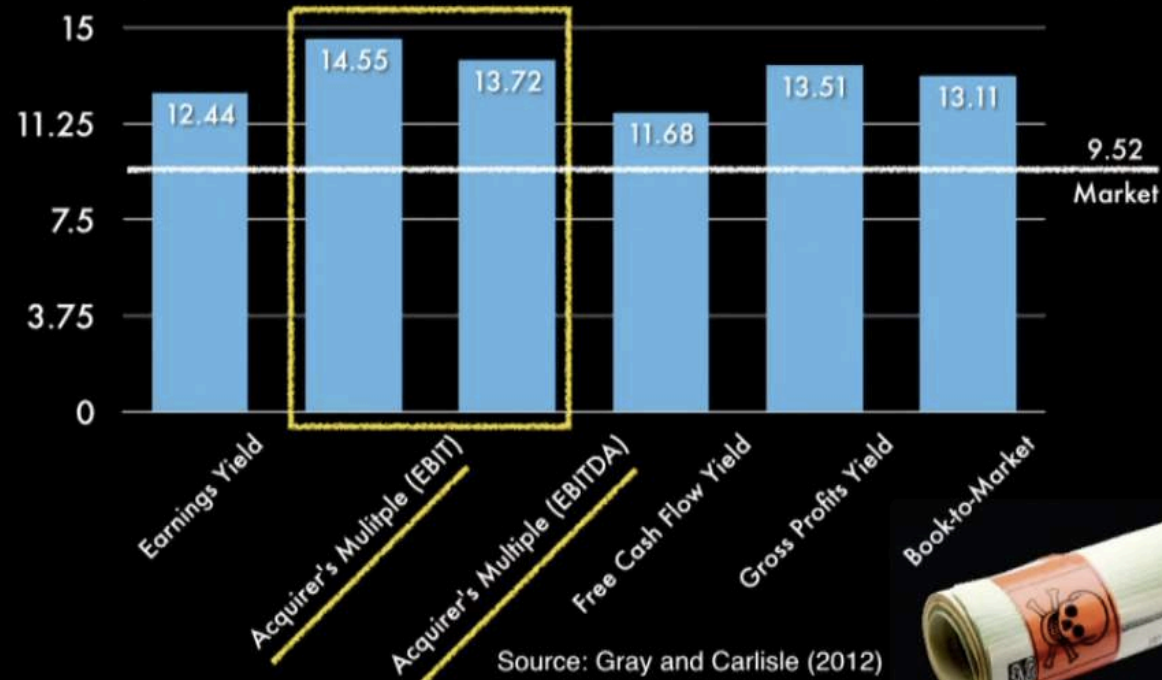


Source: Gray and Carlisle (2012)



Price/Value Ratio Test

Compound Annual Growth Rates for Price/Value Ratios VW (1964 to 2011)



Price/Value Ratio Test

Return and Risk Statistics for Price/Value Ratios (1964 to 2011)

| | Earnings Yield | EBIT AM | EBITDA AM | FCF Yield | Gross Profits Yield | Book-to-Market |
|-------------------------------|----------------|---------|-----------|-----------|---------------------|----------------|
| CAGR | 12.44% | 14.55% | 13.72% | 11.68% | 13.51% | 13.11% |
| Standard Deviation | 17.62% | 17.20% | 17.25% | 16.42% | 18.35% | 17.39% |
| Sharpe Ratio | 0.46 | 0.58 | 0.53 | 0.44 | 0.50 | 0.50 |
| Sortino Ratio (MAR=5%) | 0.68 | 0.89 | 0.82 | 0.68 | 0.73 | 0.80 |

Source: Gray and Carlisle (2012)



Four Ideas

1. Deep Value > High Growth / Quality
2. Contrarian > Naive Extrapolation
3. Simple Models > Expert Discretion
4. **The Acquirer's Multiple** > All Else



Questions?

www.acquirersmultiple.com

toby@eyquem.net

+1 646 535 8629

@greenbackd

[linkedin.com/in/tobycarlisle](https://www.linkedin.com/in/tobycarlisle)

