# A Primer on The Intrinsic Value Style Of Investment Management

**Introduction: Of Voting Machines and Weighing Machines**

The *Intrinsic Value Style of Investment Management* is a businessperson's way of evaluating a business or investment. Rather than just buying a stock, we invest in a company based on our estimate of the company's *investment value*. That investment value is what we call the *intrinsic value*. Intrinsic value will be defined in the next section, but for now let us look at why the intrinsic value concept is so useful.

There is an old Wall Street bit of wisdom that goes like this: *In the short-term, the stock market is a voting machine; but in the long-run, it is a weighing machine.* What this adage is describing is the stock market's tendency to misprice securities over the short-term - voting, as it were, based on emotional factors like greed and fear; but to recognize the true value of securities over the long-term - weighing, or measuring, that value based on the securities' *intrinsic value*. The short-term mispricing takes the form of both *overvaluations* and *undervaluations*. It is this mispricing that creates investment opportunities for the adherents to the Intrinsic Value Style of Investment Management. The Intrinsic Value Style of Investment Management is a long-term approach to investment, and therefore investment gains are expected to be realized over a 3 to 5 year time horizon.

By estimating the intrinsic value of a business or investment, we can make a determination as to whether a particular business or investment is overvalued or undervalued. As discussed, the mispricings that give rise to overvaluations and undervaluations occur quite frequently in the stock market. We look for the undervalued securities for our buying opportunities and consider the securities for sale when they become overvalued. Over the long-term, which is typically 3 to 5 years, we expect the average market price of a particular company to converge with that company's intrinsic value. In the interim (the short-term periods), the market typically continues to misprice the security creating overvalued and undervalued conditions that create investment opportunities.

**Intrinsic Value - Defined**

The *intrinsic value* of a business or other investment can be defined, in both a theoretical and practical sense, as the present value of the future cash flows of that business or investment. To determine the intrinsic value, the expected future cash flows of a business or other investment are discounted back to the present at an appropriate discount rate. The formula for determining intrinsic value and an example are shown below. While simple to define, the estimation of the factors that determine the intrinsic value is much more complex and requires an understanding of financial and investment theory as well as experience in analyzing businesses and in making the estimates and calculations. In practice, the intrinsic value of a business or investment is often estimated using other techniques and methodologies in addition to the discounted cash

flow technique described above.
The general formula, or model, for the calculation of the intrinsic value of a business or investment is,

$$V_j = \frac{C_1}{(1+k)} + \frac{C_2}{(1+k)^2} + \frac{C_3}{(1+k)^3} + \cdots\cdots \frac{C_\infty}{(1+k)^\infty} = \sum_{t=1}^{\infty} \frac{C_t}{(1+k)^t}$$

where:

$V_j$ = value of business *j* or investment *j*
$C_t$ = cash flow during period *t*
k = required rate of return on business *j* or investment *j*

This formula is a part of our business logo and is put there to constantly remind us, as well as to inform others, of the importance of intrinsic value as being one of the central and most fundamental of the investment principles.

**An Example - The Intrinsic Value of a Bank Account**

Let us use a simple bank account to illustrate the concept of *intrinsic value*. If you put $100 into a bank account that pays 5%, and you keep your money in this bank account for one year, you would have $105 at the end of the year.

Now let's reverse the calculation. If the bank promises to pay you $105 one year from now, and the interest rate on bank accounts is 5%, what is the *intrinsic value* of the bank account?[1] The answer is: $100.

This is the same methodology we use to estimate the intrinsic value of stocks or any other type of investment, although the calculations are much more complex. It should be noted, however, that in the stock market, unlike the bank account, no one is able to promise to pay us a specific amount of earnings or other cash flows. So, we must estimate the amount of those future cash flows as a part of our analysis.

**A Brief History of Intrinsic Value (What Warren Buffett Learned from Benjamin Graham)**
One of the first financial theorists and writers to use the term *intrinsic value* extensively was Benjamin Graham, who started using the term in the early-1900s. Benjamin Graham is generally credited with laying the foundation for much of modern day securities analysis. While gaining popularity in the 1900s because of Graham and others, the use of the term intrinsic value has actually been traced as far back as the mid-1800s.

The exact meaning of the term intrinsic value has been debated for over a century, and there is still no conclusive consensus. Every financial theorist and practitioner has his or her own slightly different definition and way of using the concept. Nevertheless, most definitions of the term and uses of the concept revolve around the general formula given above for the calculation of intrinsic value.

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[1] For those readers who are familiar with time-value-of-money calculations, in this example the number of periods (N) is 1; the future value (FV) is $105; the interest rate (i), also known as the discount rate or required rate of return, is 5%; and the present value (PV), which we define here as the *intrinsic value*, is $100.

The general formula for the calculation of intrinsic value was first set forth by J.B. Williams,[2] a mathematician and financial writer, in the mid-1930s (although J.B. Williams actually cites Robert F. Wiese[3] as his source for the model). It was later reintroduced and expanded by Myron J. Gordon,[4] for whom the constant-growth version of the popular dividend discount model, known as the Gordon model, was named.

Warren Buffett, one of the wealthiest and most successful investors in the world, has long been an advocate of the use of the intrinsic value concept and includes an extensive discussion of his definition for intrinsic value in the Berkshire Hathaway Owner's Manual.[5] Buffett learned the intrinsic value concept from Benjamin Graham while he was a student of Graham's at Columbia University. Both Buffett and Graham were influenced in the development of their own definitions of intrinsic value by J.B. Williams and his book, *The Theory of Investment Value*.[6]

It is interesting to note that J.B. Williams proposed dividends as the appropriate item to discount in his model, whereas today many financial theorists and practitioners discount various forms of earnings and cash flow to arrive at the intrinsic value of an enterprise.

**How Intrinsic Value Differs From Other Investment Styles**

The Intrinsic Value Style of Investment Management is a fundamentally different approach from the two other major styles of investment - *Value* and *Growth* - yet it shares characteristics with both of them. We believe that the Intrinsic Value Style of Investment Management combines some of the best elements of both the Value and Growth styles, while at the same time eliminating some of their inherent weaknesses.

Proponents of the *Value* style of investment, who often use only relative valuation measures such as price-to-earnings ratios, will often invest in anything that is cheap - regardless of the business prospects of the investment.

Those that follow the *Growth* style of investment look for companies that have great growth prospects, but often end up paying extremely high valuations for those companies.

In the *Intrinsic Value* Style of Investment Management, as with the *Growth* style, we are looking for companies that have great growth prospects - but we won't pay the exorbitantly high valuations for those companies that growth investors often pay. And, as with the *Value* style, we are looking for bargains, but we also want excellent businesses with great growth prospects. In *Intrinsic Value* investment management, we search out those unique investment situations where we can find excellent businesses and investments and pay a reasonable price for those businesses and investments. Our estimate of the intrinsic value is what tells us if the business or investment is selling at a reasonable price.

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[2] Williams, J.B. The Theory of Investment Value. Cambridge, Mass.: Harvard, 1938.

[3] Wiese, Robert F. "Investing for True Values." Barron's Sept. 8, 1930: 5.

[4] Gordon, Myron J. The Investment, Financing, and Valuation of the Corporation. Homewood, Ill.: Richard D. Irwin, 1962.

[5] Buffett, Warren E. Berkshire Hathaway, Inc. - An Owner's Manual. Omaha, Neb.: Berkshire Hathaway, Inc., 1999.

[6] Williams, J.B. The Theory of Investment Value. Cambridge, Mass.: Harvard, 1938.

**Increasing Intrinsic Value - The Key**

The real key to Intrinsic Value investment management, and what we constantly look for, are situations where the intrinsic value of a business or investment is expected to increase.

If a company's business is stagnant, we might be able to buy the company at a price, which is below its intrinsic value - but that company would probably not have any prospects for growth. Such a situation resembles the situation that Value investors often find. The stagnant company could work out to be a good investment, with the market valuation eventually rising to the company's intrinsic value; but stagnant companies usually don't stay stagnant - all too often their business decline and so do their intrinsic values.

In Intrinsic Value investment management, we focus our attention on finding excellent businesses and investments that have the potential for an increasing intrinsic value and that can be bought for a reasonable price relative to our estimate of the intrinsic value.

**Conclusion**

The Intrinsic Value Style of Investment Management can offer one of the most rational and logical ways to evaluate businesses and investments of any type. For disciplined and patient investors, the Intrinsic Value Style of Investment Management is, in our opinion, the best all-around style of investing for any stock market climate. It provides good downside protection with excellent upside potential, which is exactly what's needed in today's volatile markets. It is, simply stated, a businessperson's way of investing.

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