

Value Investing: The Proven Investment Philosophy

By Peter Lim

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Some Background of Peter Lim

Peter Lim's Past Performance

Year	Peter Lim's Performance	KLCI
2008 (From March 31 st)	-14.5%	-29.7%
2009	71.6%	45.2%
2010	52.0%	19.3%
2011	1.90%	0.8%
Overall Gain (31 st March 2008 to 2011)	127.3%	22.7%
Compounded Annual Gain (2008-2011)	24.5%	5.6%

Who is Peter Lim?



- Capital Allocator / Investor
- Full time father and his wife is not working
- Ardent but rational follower of Warren Buffett

Investment Philosophy

- A lot of people emphasize on the methods of investment without having the right investment philosophy. What you understand about investment is important

1) Difference between investment and speculation

- Investment is one of the most misused word.
- When people buy a share because its price is going to increase, they say they are investing in that share. In fact, they are just speculating/trading/gambling in that share.
- You have to have clear definition for investment and speculation

Investment	Speculation
a) Thorough analysis b) Promise safety of principal c) Adequate return	a) Buy and sell properties or stocks without thorough analysis

a) Thorough Analysis

- o Most people spend more time researching on buying a \$10,000 refrigerator than they do on buying a \$10,000 stock
- o Abundant information in the internet era makes people go straight to the methods without forming a strong investment philosophy, which can lead to disaster

b) Promises safety of principal

- o When it comes to promises safety of principal, people always mistaken it with “guarantee”. However, it **does not equal to guarantee**.
- o For example, if you buy a property which promises an annual rental of \$10,000, and that a lot of people are going to rent this place because it is near to a college or working place. If you buy the property for \$50,000, you receive \$10,000 rental annually, after 5 or 6 years you will earn back the initial investment of \$50,000, not to mention the appreciation.
- o In that sense, the property promises a huge margin that you cannot lose money. So your principal is safe.
- o **Margin of safety** If there is a wide gap between what the asset worth and the price you pay for it, the margin of safety is wide. When worst scenario happens, it is unlikely you will lose money. (Buying an investment at a great discount)
- o Example of a casino:

In a casino, sometimes the banker of a particular table can lose money. The odds of them winning in a single round is, probably, 53%, the odds of them losing is 47%. If you play one or two round, you might win from them. Given the cap in the casino, and the diversification

to hundreds of tables. So the table which lose money turns out to be the odd one, and it doesn't affect overall profitability. If the players play longer, the most likely the player will lose.

- o Fixed deposit is considered an investment in this sense, because it promises safety of principal, and an analysis can be done to compare which bank offers the highest rate. But it doesn't fulfill the following criteria.

c) An Adequate Return

- o FD does not give an adequate return against inflation.
- o An adequate return must be a few percentage above the inflation rate, and it gives adequate return to the time and effort you put into researching the stocks. For example, if you are full time investor, you might want an adequate return at about 10% to 15%. But if you are a part-time investor, the number of hours you spent in a week on research is not much, then you cannot expect 30% of return, which is higher than those of full time investor.
- o If the effort level is lower, maybe a return of 8% to 10% might be adequate. But most people cannot achieve 8% to 10% of return because they do not do a thorough analysis, either they do not have the knowledge or they are not interested, or they are lazy.

Margin of Safety

- If you are an engineer, and you are asked to build a bridge with the average load capacity of 10,000 tons. You won't build a bridge with load capacity of 11,000 tons, since you have to prepare for the worst case scenario. Thus you might want to build a bridge which can load 30,000 tons, so that when the bridge is overloaded it will not collapse.
- In investment context, **margin of safety means the price you pay compared to what you think the thing is worth.**
- For example, if you think something is worth RM1, you do not buy it for RM0.95. Because if you do so, your margin of safety is only 5% ($0.05/1 \times 100 = 5\%$), which is pretty low.
- Apply the same case for a company's intrinsic value, which is very subjective and subjected to various factors. If there is a change in interest rates or economic crisis happens, the company's stock price goes down, you might lose money if you buy its stock (which is worth RM1) for RM0.95.
- But if you buy it for RM0.40 or RM0.50, you have a large margin of safety. So if its value dropped from RM1 to RM0.90, you are still okay with it.
- The normal margin of safety:

At least 33% discount of the price

- The better the discount is, the safer is your investment, and the higher is the potential return you are going to get.
- If you buy something that worth RM1 for RM0.20:
 - i) the chances of you losing money is minimum
 - ii) even if it doubles to RM0.40, it is still very cheap
- The lesser the people that apply this method, the better it is for the people who apply it. The lower the demand for the stock, the more stocks you could buy at discounted price. Whether you can find stocks that offer at least 33% of discount, it depends on the effort and time you put into company and stocks research.

Note: Peter Lim is not going to give away any stock tips in these seminars, because it does no good other than encouraging laziness. Rather than following others in buying and selling stocks blindly, you have to do your own thorough analysis, so that you are more confident in making deals. Do not go for TIPS, go for EDUCATION instead.

How We Should Think About the Market

Quoting Benjamin Graham's Mr. Market metaphor:

- Imagine you are in a business with Mr. Market, where both of you own half of the business each. Everyday Mr. Market would decide to offer a price to buy up half of your business or sell you half of his business, depending on his mood.
- In some days, when Mr. Market is in a good mood, he would offer a very high price to buy your business or sell his business at the same high price. In other days, when he is not feeling good, he would offer to sell his business at the very low price or buy yours at the same low price. It is up to you to accept the business or ignore him.
- But most of the time, **it is best to ignore Mr. Market**, and focus instead on what the company is doing.
- The market is just a place to buy others' shares to increase your holding, or sell off your shares. In that sense, if the market offer a price, you can choose to take advantage of it or just ignore it. However, **you should not be influenced** by its motion.
- Many people are influenced by Mr. Market's emotion. When the price goes up, they feel happy that their shares are making money, and they resolve to buy more shares. But they forgot they are buying at a higher price. The higher the price, the more they want to buy. However, this makes no sense.
- When the market price drops, people would feel sad over the loss of their money. But you will only lose money if you choose to engage with market motions.
- Of course, if you have done a thorough research to make sure that the price of the shares worth much more than the price you pay, you should be happy whenever the price drops. Those who do not react this way did not do a thorough research. They probably spend none of their time to look at the company's reports. These people are speculating/trading/gambling, not investing.
- The way these people react is good for true investors. Someone has to sell cheap to match the investors who want to **buy cheap**.
- **Value investing** is a lonely path in this sense. You buy when everyone wants to sell, and sell when everybody wants to buy more.
- **Value investing** is very different from technical analysis. In technical analysis, you use the past prices to predict the future stock prices. If the price is in an upward trend, the technical analysis will predict the price increase to go on and on. Let's say for the past two weeks, the stock price has been dropping. They will then think it is in a downward trend, and sell off the stocks because they predict the price to go down for the next two weeks too.
- This way is against business rationality. Technical analysis does not focus on the company's performance, the focus is on short-term price difference. For me, this is speculation.
- Another parody of the irrationality of technical analysis:
 - o Imagine you have just bought a house for \$100,000. Then you tell your real estate agent to sell it off if someone offers \$90,000 tomorrow, because it is on the downward trend.

Ensure that whatever you buy, it must worth much more than the price.

- You must have a **method of estimating what the thing is worth**.
- If you buy a house for \$500,000, you must do some research to ensure that the house is really worth \$500,000. Do not depend solely on the opinions of real estate agents or other people.

- Price you pay is **different** from what the thing is worth.
- Price is what you **PAY**. Value is what you **BUY**.
- There are many companies to choose from. You can choose not to go for the difficult ones, and move on to the next companies.
- Investing is not Olympic sports, you do not get more points on challenging higher level of difficulty. In investment, it is better to go for the simpler ones, so that you can estimate what the company is worth based on its EPS, etc., so that you know the good price to pay.

Benjamin Graham

The philosophy mentioned so far originated from Benjamin Graham. Benjamin Graham has written two great books on investment:

1) Security Analysis

2) The Intelligent Investor: The Definitive Book on Value Investing. A Book of Practical Counsel.

- **Three most important chapters** in the book:
 - Chapter 1: Investment versus Speculation: Results to be Expected by the Intelligent Investor (Defining difference between investment and speculation)
 - Chapter 8: The Investor and Market Fluctuations (Mr. Market and how we should think about the market)
 - Chapter 20: “Margin of Safety” as the Central Concept
- These three chapters have been often repeated by Warren Buffet.

Stock Selection Criteria

Rating Stocks

	Good Company	Mediocre Company	Bad Company
Good Price	Best buy Earn high profit in relation to the capital they used	Third best buy Earn a so-so profit in relation to the capital used (8% - 12%)	Should be avoided -Losing money: 3 years of losses out of 5 years. If there is an one-off loss, you have to study further why the loss occurred. -Company makes profit of 1%-2% in relation to the capital used, or if the pay to the directors is more than the company's profit.
Fair Price	Second best buy Good company at a fair price		
Bad Price	If you buy a good company at a very high price, it is a bad price. There is nothing wrong with the company, but the price you pay is too much compared to what it is worth. There is no margin of safety . You have to avoid buying at high price .		Avoid at all cost! (see the example (5) below)

Tips:

1) Try to find a good company which sell at a good price. This kind of company would give you compounding return of about 25% to 30% per year. It is possible for you to get good return in 6 months or 1 year. But this kind of opportunity is rare. It happens usually during a market crash, then you could find a good company at good price (low price). But usually the chance is rare, you have to do more analysis to uncover such chances.

- Company is doing the same business over the year, the intrinsic value is easier to define.
- Company is getting a good return in relation to the capital used.
- 70 out of 1000 companies in Malaysia are good companies.

2) Example: Back then in 2000s, Microsoft's price went up to US\$80. Five and a half year later, the company's profit doubled, but the share price dropped to US\$40. Why is that so?

- o The price investors paid in 2000s is about 80 times what the company is earning. But in 2006 the price dropped. If you buy at a high price, the chance you lose money is very high. **Valuation matters.**
- o If you want to find a share with good price, it is unlikely you would find it in popular places.

3) Mediocre companies: about 200 out of 1000 companies (return between 8% and 12%)

4) Price changes depending on market condition. You can create a list of companies and keep track of the price changes (updating weekly). Whenever the price dropped to a level which provide you adequate margin of safety, then you should take action.

5) Avoid bad company at all cost!

- For example, company with \$30 million of shareholders fund, holding debt and very little cash. At one time, the share price was bid up from 8 cents to \$2 within a month. If you do a valuation on the company, \$2 multiplied by the number of shares, the company is valued at, let's say, \$350 million. If you look at the company's reports, and found that for the past 5 years it has been losing money for 3 years, and another 2 years just achieved break-even. The price shareholders paid was 12 times what the company worth and the PE is 100. After few weeks, Security Commission put a warning on the share, and the share price dropped by half. But still the price is not a good price, the share is not a good buy.

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