The Determinants of the Successful Value Investment

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Abstract. The evolution of value investing theories from Benjamin Graham's cigar butt strategy to Warren Buffett's emphasis on high-quality companies with reasonable prices reflects the changing landscape of the investment world. This paper explores the relevance of traditional value investing principles in the context of the Internet era, where rapid technological advancements and societal shifts have reshaped investment strategies. Through an analysis of historical case studies and contemporary examples, the paper identifies four key determinants of successful value investing: the development of human society, technology innovation, the life cycle of an industry, and timing. It argues that investors must adapt their strategies to align with epoch development and technological advancements, focusing on companies with strong fundamentals and growth potential. Moreover, it highlights the importance of selecting the right time to invest, amidst market fluctuations and news-driven volatility. While acknowledging the inherent uncertainties in investment decisions, the paper emphasizes the need for investors to continually reassess and adjust their strategies to navigate the dynamic investment landscape effectively.

1 Introduction

With the rapid development of new technologies, Internet era is emerging endlessly. From Benjamin Graham’s cigar butt investing strategy to Warren Buffett’s conclusion that buying in good companies with reasonable prices are better than buying in normal companies with low prices, as well as the emerging of technology stocks nowadays, it is of great significance to determine the right stock for value investment according to epoch development. Classical theories of value investing in the past need to be evolved into new theories which are more appropriate for current social background.

In retrospect, Warren Buffett is a legendary investor. Benjamin Graham is his investing mentor, who is generally considered the father of security analysis and value investing [1]. Before Graham, bond investment took up the most proportion of capital market investment, while stock investment was often regarded as a speculative behaviour. In the background of the great depression, stock prices were far beyond the intrinsic value of the company. Graham found that the actual value of the stock can be calculated by analysing a company's financial information [1]. He concluded that investors would benefit greatly from investing in companies where the stock prices are no more than 67% of their net current asset value per share [2]. Graham's cigar butt investing strategy was known as the earliest value investment and it was highly successful after the great depression in the 1930s, when the market sentiment was very low and many stock prices were considerably below the company's value. However, in the current social background, networking enables lots of information to be disclosed in front of the public, hence it is much more difficult for investors to find companies that have promising future but are significantly undervalued.

Warren Buffett was keen on cigar butt investing strategy in his early investment career. For example, he invested heavily in Dempster mill manufacturing company in 1956 and Berkshire Hathaway in 1962. However, after these cases, Buffett found that buying in a company with bad operation at a very low price may not be a good decision, because the low price may not be actually cheap and the advantage in price would be eliminated by low return of the company [2]. In addition, with the recovery of the market, the amount of cigar butt stocks were declining. Though the rate of return of cigar butt investing was high, the amount of return was not high. Hence, Buffett started to changing his methodology that learned from his teacher Benjamin Graham.

With the help of his business partner Charlie Munger, Buffett concluded that buying in good companies with reasonable prices are better than buying in normal companies with low prices [2]. For instance, he bought more Coca Cola stocks in 1988 even when the stock price was higher than that in 1987, as he considered that the company had a strong brand loyalty among America and the company had been continuously growing. Moving into the Internet era, technology stocks began to coming into public views. Buffett changed his strategy of never investing in technology stocks and started to invest heavily in Apple, because Apple occupied an irreplaceable position in the current social background.

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This article analyses the four determinants of successful value investing—namely the development of human society, technology innovation, the life cycle of an industry, and the timing of investments—this article delves deeper into the intricate interplay between these factors in the contemporary investment landscape shaped by the Internet era. By examining historical precedents and current market trends, it seeks to provide investors with a comprehensive framework for navigating the complexities of value investing in a rapidly evolving world. Furthermore, the article explores the implications of these determinants on investment strategies, emphasizing the need for flexibility and adaptability in response to emerging opportunities and uncertainties. Through empirical analysis and strategic insights, it aims to empower investors to make informed decisions and capitalize on value investment opportunities amidst dynamic market conditions. Ultimately, by offering actionable guidance grounded in both theory and practice, this article endeavours to assist investors in identifying and capitalizing on the most promising stocks for value investment, thereby enhancing their chances of long-term financial success in an ever-changing investment landscape.

2 Development of human society

The human society has switched from agricultural society to industrial society and finally the Internet era. In different stages of society development, different types of stocks turns into public view. Investors should select stocks according to epoch development.

Industrial society emerged in the 1700s as the development of machines and factories replaced the plow and other agricultural equipment as the primary mode of production. The Dempster Mill Manufacturing Company was founded in Beatrice, Nebraska in 1878 by Charles B. Dempster. Its main business was to produce irrigation devices powered by wind or water, such as windmills and water pumps. The quality of products were quite good, so that the company performed well compared with a large number of competitors. After the second industrial revolution, electricity became the main source of power. The born of electric pump was a huge damage to the company, as it was much more efficient and more reliable than water and wind [2]. Hence, it was an inevitable trend for the company to go downhill and the prices of stocks were significantly undervalued. Considering that the stock prices are no more than 67% of their net current asset value per share and the company's main business does not consume its capital, Buffett bought in the stocks. However, due to the obsolete ideas of the management teams, revolution of the company became a tough problem. Buffett continued to buy in more stocks until he got total control of the company. With the help of new CEO Harry Bottle, luckily the value investment finally turned out to be profitable [2]. However, for ordinary investors, buying in a company that falls behind epoch development is a risky decision, because usually investors don't have the ability and huge amounts of funds like Buffett to get total control of the company and improve the situation.

Moving into the Interne era, technology stocks began to coming into public view. Buffett once said, technology is not something investors understand, so investors do not invest in it [3]. He emphasized that investors should focus on long-term value of a company rather than short-term fluctuations. As the technology industry is undergoing tremendous changes, each company faces fierce competition and technological iteration, so that there are too many uncertainties and risks in the future. However, Buffett bought heavily in Apple in 2016. He found that Apple had a moat, which was a comparative advantage that set it apart from rivals [3]. Apple iPhone plays a very important role in people's life, and its value may exceed the value of much more expensive items. In addition, Apple has a good management team and stable cash flow. Buffett believed that Apple would be a company with potential growth, so that he bought in Apple. Looking back in the last decade, in 2014 the average stock price was $20.45, in 2016 the price was $24.07, while in 2023 it had surged to $171.9 [4]. It showed a dramatic increase in stock price in the past as well as a strong upward trend in the future.

The analysis of Buffett's transition from traditional investment strategies to embracing technology stocks underscores the significance of aligning investment decisions with the evolving dynamics of human society. In the Internet era, technological advancements and societal shifts have become pivotal drivers of economic growth and market trends. As Buffett recognized, the landscape of value investing is continuously shaped by these broader societal developments, necessitating a nuanced understanding of the prevailing zeitgeist. Investors must remain attuned to the pulse of technological innovation and cultural shifts, as these factors exert profound influences on the performance and prospects of companies across various sectors. By acknowledging the interplay between societal evolution and investment opportunities, investors can position themselves to capitalize on emerging trends and navigate the complexities of the modern investment landscape with greater efficacy. Thus, the development of human society emerges as a critical determinant of successful value investing, underscoring the imperative for investors to adapt their strategies in accordance with the prevailing epoch development and seize opportunities presented by the ever-changing socio-economic milieu.

3 Technology innovation

With the rapid development of technology, the efficiency of resource utilization has increased dramatically from 1700s to 2000s, leading to strong upward trends of some typical stocks. Investing in stocks that represent the latest technology innovation can be a good strategy.

During the first industrial revolution, James Watt invented steam engine in 1769. It replaced the devices powered by water or wind in the past. During the second industrial revolution, the internal combustion engine was invented by Nikolaus Otto in 1876. Technology innovation of both steam engine and internal combustion engine improved the efficiency and production exponentially. On June 16, 1903, Henry Ford and 12 other investors created Ford Motor Company. From 1920s to 1930s, the company was producing more than half of America's automobiles, its global presence also expanded significantly, making Ford a renowned company among America. From 1973 to 2000, the stock of Ford showed a strong upward trend. Ford survived during recession from 2000 to 2008, even though the stock price had been significantly declined. After that, the price started to recover and showed an overall upward trend despite the down turn during COVID-19 [5].

From 2004 to 2008, Tesla grew substantially and developed its first automobile, The Roadster. In order to remain competitive in the global market, Tesla aims to create more affordable electric cars to attract a broader customer base, and it is now a leader in the electronic car industry [6]. Compared electric cars with traditional fuel gas cars, the cost of charging electric cars is much lower, as the electricity is cheaper and has better energy efficiency. According to a research, the EPA estimates that the electric Kia EV6 would cost $550 to fuel over the course of a year, while the gas-powered Kia K5 would cost $1950 to fuel [7]. Besides, electric cars adopt clean energy with zero carbon emission, so that the governments advocate consumers to purchase electric cars and give them subsidies. This policy further increases consumers' passion in switching to electric cars, hence substantially rises the stock price of Tesla.

In the early 2020s, Ford faced fierce competition from Tesla and pressure to cut vehicle emissions. CEO Jim Farley said, the traditional architecture has become an obstacle to us and must be changed. This is the biggest opportunity for growth and value creation since Henry Ford started to scale the Model T [8]. Hence, Ford announced an electrification and R&D commitment of over $50 billion through 2026.

In conclusion, Ford's stock price shows a strong upward trend from 1973 to 2000 because of the utilization of internal combustion engine. Tesla's stock price keeps going up because of its new technology innovation and leading position in electric car industry. In order to compete with Tesla, traditional gas fuel car manufacturer Ford invests more in innovation of electric cars. For investors, to move with the changing times, they should select stocks that already have leading technology, or select stocks according to prediction of future technological achievements.

4 Life cycle of an industry

The business life cycle includes startup, growth, maturity and decline. Investing in the startup and growth of a company is a good strategy, while investing in decline process is risky and should be avoided.

Warren Buffett took over the control of Berkshire Hathaway Inc. in 1965. The company was founded as a textile manufacturer. The reason according to Buffett was that, the investors bought Berkshire Hathaway at a good price, which fits the cigar butt investing strategy [9]. Another reason was that the management team of the company were only willing to pay $11.38 per share for the stocks that Buffett got, while their former agreement was $11.5 per share. Buffett was angry about the dishonest behaviour, after getting control of the company, he fired the CEO. However, in 1965, textiles were a declining industry, because the foreign countries could produce the same product at cheaper price. A lot of Buffett's money was tied in the textile business, after about 20 years' effort, even Buffett was unable to turn losses into profits. Ultimately, Buffett closed the textile industry, and he summarized this investment as "a big mistake". He also concluded that the textile industry is not good, if Berkshire had a starting point as an insurance company, its market value would had doubled [2]. This case also proved his conclusion of buying in good companies with reasonable prices are better than buying in normal companies with low prices in his later career.

After the huge success from See's candy company in 1972, Buffett realized the great power of brand loyalty. He changed from investing in cigar butt stocks to accompanying the growth of high-quality companies. In 1985, Coca Cola company invented a new type of coca cola, which had a better flavour than traditional one, then the company announced that the new recipe would replace the old one. Surprisingly, most of the consumers protested vigorously against the new coca cola, hence the schedule had to be cancelled. From this event, Buffet found that traditional coca cola had already occupied an irreplaceable position among Americans, and the company was growing rapidly. During the growth of Coca Cola company, Buffett started to invest heavily in the stocks. Even at the end of 1988, when the stock price was higher than that in the previous year, Buffett still bought in more stocks. He said, the investors expect to hold these securities for a long time. In fact, when people own portions of outstanding businesses with outstanding managements, their favourite holding period is forever [10]. According to the statistics, total dividend that Buffett earned was about $9.4 billion as of 2022 [11].

In conclusion, even the legendary investor Buffett cannot make profits through declining textile industry. Hence, investors should not buy in sun-set industries as they faces the risk of shutting down. Instead, investors should invest when the company is growing rapidly, such as the Coca Cola company case, as it still has the potential to grow in the future.

5 The right time for investing

The stock price is always fluctuating depending on current market sentiment and news report. Investors should select the right time for investing, otherwise they may make a loss.

According to André Kostolany's theory, the relation between stock exchange and economy is like a man walking his dog. The man walks slowly, the dog runs back and forth [12]. Surroundings can easily influence the dog and make it run around the man. Under the control of the man, the dog cannot run far away and finally will run back to the man, just as stock price fluctuations are often far exceed fundamental fluctuations, and ultimately it will return to the fundamentals.

The dog may become out of control when the bear market comes. For instance, in 2008, which is the time of the great recession, the market sentiment was very low. The stock prices were far beyond their intrinsic value, but most of the investors were pessimistic about the market and would not buy in stocks. However, Buffett continued to buy in stocks even if the stock price plummeted. According to his long-term investing strategy, anyone can not precisely predict short-term movements of the stock market, but he was sure that the market would go up before either the market sentiment or the economy turns up [13]. He suggested that even though it was bear market, it could be the right time for investing. Buffett wrote in the Times article. In short, bad news is an investor's best friend. It lets investors buy a slice of America's future at a marked-down price [13].

In addition to market sentiment, both good news and bad news can have impact on the stock price. Taking Alibaba as an example, the following three news have significantly influenced the stock price. On October 3rd 2020, the $34.5 billion IPO of Ant Financial was suspended, with $984 million fined by Chinese regulatory authorities, claiming the financial technology provider violated laws related to corporate governance and consumer rights. The stock price decreased from $299.51 on November 2nd to $285.57 on November 3rd, which was about 4.65% decline [14]. On December 24th 2020, the state administration for market regulation had launched an investigation into Alibaba's "one out of two" business practices. The case was that Alibaba’s competitor JD had claimed that Alibaba forced sellers to either sell products on the platform of Alibaba or to sell them on JD. The stock price dropped from $256.18 on December 23 to $222.00 on December 24, which was approximately 13.35% decline [14]. On April 10th 2021, Alibaba was ordered to pay a fine of $2.8 billion after antitrust regulators concluded that the online shopping giant had been behaving like a monopoly. After the announcement of the fine, the stock price rose from $223.31 on April 9th to $241.68 on April 12th, because investors thought that the government’s regulation had come to an end, and uncertainties and risks in the future are mostly eliminated [14]. From those three events, it is proved that the stock price may be far beyond or above its intrinsic value even if the fundamental situations of the company have not changed. Under the huge impact of news, the stock price is very difficult to predict and there are too many risks, so that it may not be a good idea for investors to invest immediately.

In conclusion, investors should not be fooled by current market sentiment and release of news. Instead, they should focus more on the fundamental situation of the company to see if it has the potential to grow. Aiming to make money within a short time period when the stock price fluctuates vigorously may be very risky.

6 Conclusion

This article concludes that the value investment theories have evolved significantly along the long history. From Benjamin Graham’s cigar butt strategy to Warren Buffett’s conclusion that buying in a company with bad operation at a very low price may not be a good decision, focusing on long-term growth of high-quality company rather than short-term fluctuation of the market, investors should also change their strategies flexibly according to epoch development.

In the past, the cigar butt investing strategy invented by Benjamin Graham was successful, however, nowadays investors can almost get full information of the companies, so that it is almost impossible for them to find large number of cigar butt companies. The value investing theory was then evolved by Warren Buffett, he concluded that buying in a company with bad operation at a very low price may not be a good decision. However, Buffett also makes mistakes. Investors should invest in the growing industry like Coca Cola company, and sell stocks of the declining industry, avoiding the same mistake for the Berkshire Hathaway case. In the background of the Internet era, investors should also recognize the feature of the times, select stocks that have advanced technology and promising future like Tesla. The right time for investing is also an important determinant. As stock price can be easily influenced by market sentiment and news, investors should focus more on the fundamentals of the company, rather than pursuing short-term profits in the fluctuating market which is very risky.

However, there are also some limitations, as nobody can precisely predict the future. There are still several variables that will determine the successful value investment. For the technology stocks like AI, the development of the industry in the future may not be sustained successful as many authorities have accused the company for copyright issues. For the growing industry of VR, which had been popular in last three years, hadn’t developed to a large scale as there were still many skill problems that couldn’t be fixed. For the company represented by the stock, the change of management team and new policy regulations in the future may also influence the performance of the company. As there are always uncertainties in the future, what investors can do is to track the risks and keeps adjusting their investing strategies.

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