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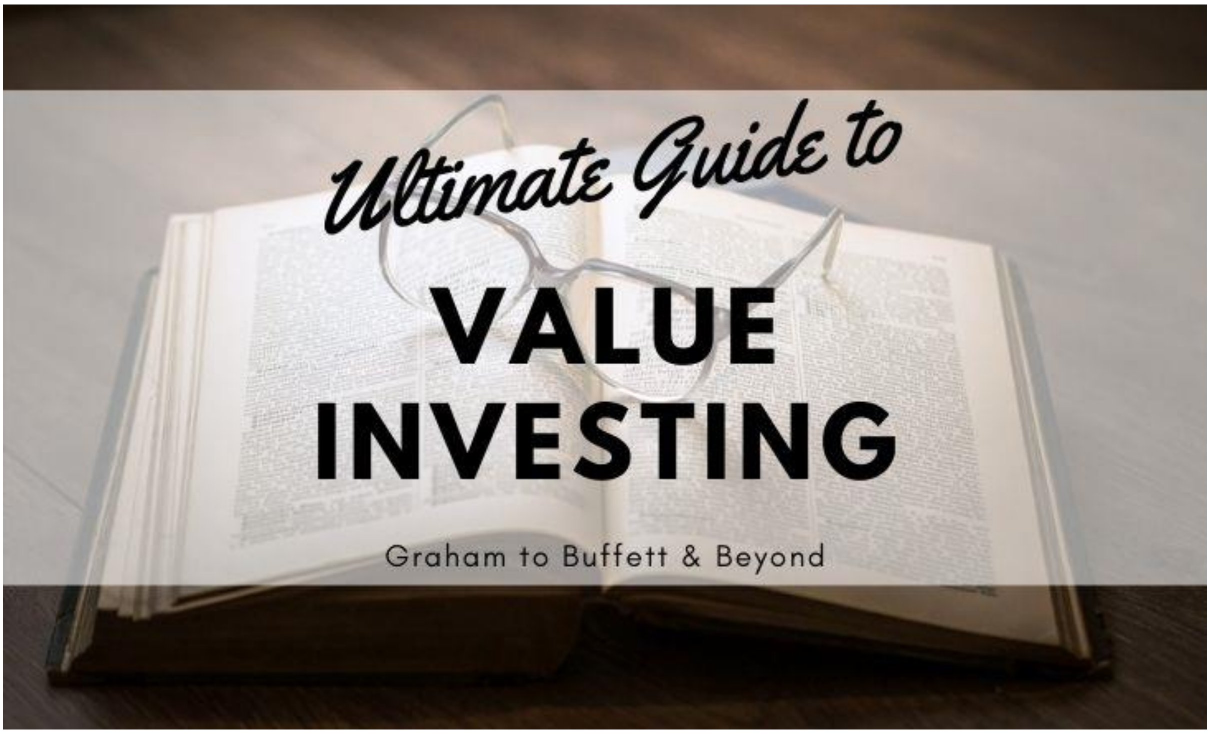

By

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Value Investing, Strategy & Screening Guide

Our In-Depth Guide to Value Investing Will Help YOU Start A Value Stocks Portfolio With Strategies & Tips on Fair Value, Margin of Safety & More

I have been investing in stocks for over 20 years and am a certified market analyst with IFTA. I hope to help you understand value investing, its strategies, and how to implement a value investing screener to help you find deep value stocks. Let's start this book with a few basics.

The Definition of Value Investing

Value investing is a school of investment based on the assumption that the stock market participants do not value a company correctly. Value investors believe they can make a healthy long-term profit by identifying profitable companies that the stock market undervalues.

What is Value Investing?

Value investing is both a philosophy and a strategy of investment. The philosophy is that an asset's value is its most important characteristic. The strategy is that the market cannot properly value stocks, but well-informed investors can.

Value gurus like Warren Buffett believe most stocks are either overvalued or undervalued.

Ultimate Guide To Value Investing

To determine the real value, value investors usually ignore the stock price and look at the entire company. Value investors will examine a company's sales data, financial reports, holdings, real estate, patents, intellectual property, research and development, and many other factors.

The dream of value investors is to find a good stock that the market dramatically undervalues. Thus, many value investors are bargain hunters who are seeking the most bang for their buck.

Many value investment strategies emphasize the intrinsic or real value of stocks. A popular value formula is to calculate the amount of cash a company generates. To determine the intrinsic value, investors examine a wide variety of metrics.

Value investment flies in the face of many modern notions about capitalism. Many value investors reject the efficient market hypothesis and believe the markets are usually inefficient and inaccurate.

Another popular belief of value investors is that investment industry professionals and the media cannot be trusted. These investors think the only reliable information about a company is the financial data. They ignore everything else.

A classic value investing strategy is to seek companies with a share price that is way below the intrinsic values per share. Followers of this strategy believe that the stock price will rise over time to reflect the company's real value.

Most value investors are focused on the company fundamentals; this means they focus on the financial reports, income statements, balance sheets, etc. Essentially, there are numbers of people who use financial data to help them estimate intrinsic value. Value investing is often confusing because there are many such financial metrics and calculations.

The value gurus add to the confusion by emphasizing different sets of numbers and factors. Warren Buffett emphasizes the future free cash flow as one of the company's most important criteria. However, Buffett's teacher Ben Graham emphasized the ability of a company to generate dividends for its investors consistently.

Most value investors practice a buy and hold investment strategy. In buy and hold, a person purchases a stock and keeps it for a long time.

The classic value investing idea is that you will not lose money on a stock that holds its intrinsic value. The usual value investing challenge is to identify the low-priced undervalued stocks with high intrinsic value.

Most value investors can be considered contrarians because they assume popular wisdom about stocks is wrong. A good way to think of value investing is that it believes the market is always wrong.

Benjamin Graham Value Investing

The British-American investor and economist Benjamin Graham is widely viewed as the father of value investing.

Graham first laid out his principles of value investing in his 1934 textbook *Security Analysis.* Graham popularized value investing with his 1949 classic stock investing book, *The Intelligent Investor*.

Both books are based on stock investing lessons Graham and others taught in a popular Columbia Business School course in New York City. *The Intelligent Investor* first outlined what is now widely viewed as value investing.

The *Intelligent Investor* teaches Graham's most influential ideas, including Mr. Market and group investment. Mr. Market was Graham's characterization of the stock market.

Graham liked to describe the stock market as a lunatic named "Mr. Market" who sold stocks at insane prices. In Graham's view, the key to making money was to catch Mr. Market when he was selling valuable stocks at low prices.

Graham's approach is based on the theory that the market is inherently irrational. Mr. Market was Graham's way of explaining that notion to ordinary people.

One of Graham's primary teachings is that investors need to evaluate stocks for their ability to make money. Graham's definition of a good company is one that generates lots of cash. Graham's definition of a good stock was equity that generates high dividends.

Graham believed the ability to make money is the only criteria by which you should judge stocks. His first rule of investing best sums up the man's philosophy. When faced with new stock, Graham advised investors to ask, "does it make money."

Graham's second rule of investing was to "see rule number one." The ability to make money is the most important attribute of any investment in Graham's teaching.

To identify such stocks, Graham invented what he called the group approach. In the group approach, you identify criteria for undervalued stocks and search for equities that meet that criteria.

Graham attracted attention for claiming that stocks picked with his group approach gained value at twice the Dow Jones rate. The *Dow Jones Industrial Average* was the most popular stock index in the 20th Century.

Graham was an active investor who worked on Wall Street for decades. Graham was openly critical of the stock market, most investors, and corporations.

Today Graham is best known as the primary teacher of his most famous pupil, Warren Buffett. Buffett studied under Graham at Columbia Business School and worked at Graham's company, the Graham-Newman Partnership, early in his career.

Graham's influence extends far beyond amateur value investors. Many mutual funds employ Graham's diversification strategies, group investment, portfolio management, and financial analysis in their stock picking.

The key criteria of a Graham value investment are that a company needs to be cheap and make a lot of money. This simplicity is what makes Graham's value investing so popular.

Many investment professionals, however, view Graham's ideas as too limited for today's complex markets.

Warren Buffett Value Investing

Warren Buffett is the most successful and famous value investor in the world for a good reason.

Buffett is widely admired because he was the world's third-richest man on September 30, 2019. *Forbes* estimates Buffett had a personal fortune of $82.1 billion on that day. Most of that fortune comes from stock in Buffett's company Berkshire Hathaway (NYSE: BRK.A). Much of Berkshire Hathaway's money comes from its stock holdings, which Buffett helps pick.

Buffett bases his value investing in Graham's philosophy, but he employs different tactics and criteria. Unlike Graham, Buffett is willing to pay higher prices for companies he considers good.

Buffett will buy more expensive stocks that meet his criteria. His portfolio has contained some expensive stocks, including Apple (NASDAQ: AAPL), at various times.

Another difference between Warren and Graham is that Buffett will buy large amounts of what he considers good stocks. Buffett's strategy is to concentrate his investment in moneymaking equities.

When he analyzes a stock, Buffett pays the most attention to its cash flow and assets. Buffett's core belief is those good companies always have lots of cash.

One difference between Buffett's approach and Graham is the Oracle of Omaha's focus on growth. Buffett will pay extra for companies with a healthy rate of growth like Apple.

Berkshire Hathaway will sell companies with a slow rate of growth. Buffett sold much of his stake in Walmart (NYSE: WMT) in recent years because of that company's low growth rate.

Another Buffett belief is that investors need to keep large amounts of cash on hand. Berkshire Hathaway made headlines for accumulating $122.38 billion in cash and short-term investments in summer 2019.

Investors need lots of cash so they can take advantage of opportunities fast, Buffett teaches. Investors also need cash to cover emergency expenses and to borrow against them.

Like Graham, Buffett is a contrarian famous for his skepticism of the market, the media, investors, and the investment industry. Buffett dismisses investment fads, popular wisdom, professional fund managers, and new technologies.

In recent years, Buffett has become increasingly critical of the wealthy and the American political system. Buffett pledged to give 99% of his fortune to charity to encourage the rich to give back.

Buffett is a celebrity who has achieved rock-star status among investors. CNN claims over 16,200 people attended Berkshire Hathaway's carnival-like shareholders' meeting in Omaha, Nebraska, in May 2019. One highlight of the shareholders' meeting is a public question-and-answer session where Berkshire Hathaway stockholders can ask Buffett anything.

Buffett's value investing combines Graham's philosophy with a contrarian view of the markets and a cynical view of human nature. Buffett likes to tell people to buy companies so simple "even somebody's idiot nephew" can run them. The notion being that "somebody's idiot nephew" will be in charge at some point.

Buffett's value formula is hard to calculate manually because it emphasizes several divergent criteria.

Unlike most investors, Buffett emphasizes a cash flow and rate of growth over the share price.

Buffett does not take a lot of risks in his investing. He makes large investments in stable, simple businesses, including insurance, consumer goods, retail, finance, and media.

Buffett's methods are not for everybody because of the time it takes to make profits, emphasizing long-term stable profits. Too many people are focused on short-term trading to make money, which is much riskier. Many people, however, swear by Buffett and his investing wisdom.

Can You Invest Like Warren Buffett?

Actually, the answer is a resounding **YES!**

Warren Buffett has been so vocal about his investing principles over the years, and even his daughter wrote a book called Buffetology about how Buffett's investing principles.

We have actually distilled it all into our blockbuster post called:

4 Easy Steps to Build The Best Buffett Stock Screener

Value Investing Concepts

Most value investors base their investing decisions on three basic concepts. Each of these concepts is a big idea that underlies value-investment philosophy.

Three major value investing concepts are:

Intrinsic Value

Intrinsic value is the price of a business calculated through fundamental analysis of a company's assets and cash flows.

A classic formula for intrinsic value is the market value of a company's assets added to its cash flows. To arrive at intrinsic value, Buffett value investors will ignore a company's share price in valuing the company.

Instead, Buffett values companies he invests in as if he was buying the entire business for cash. Once these investors calculate intrinsic value, they compare it to the share price and market capitalization. If the intrinsic value is substantially higher than the market capitalization, you can consider the company a value investment.

Buffett arrives at the intrinsic value by studying financial numbers and doing real-world research on its business model and competitors. Berkshire Hathaway could compare a company's products and sales to its competitors, for instance.

A simple way to think of intrinsic value is the cash value of everything a company owns. A slightly more complex estimate will include cash flows or projected cash flows.

Most value investors use several methods of analysis to arrive at intrinsic value. There is no single best formula for intrinsic value. Instead, investors usually base intrinsic value on the calculation that best fits their belief of what makes a great company.

Margin of Safety

The margin of safety is the difference between the share price and a company's intrinsic value.

In classic value-investing theory, the margin of safety is the level of risk an investor can live with. The margin of safety is an estimate of the risk a stock buyer takes.

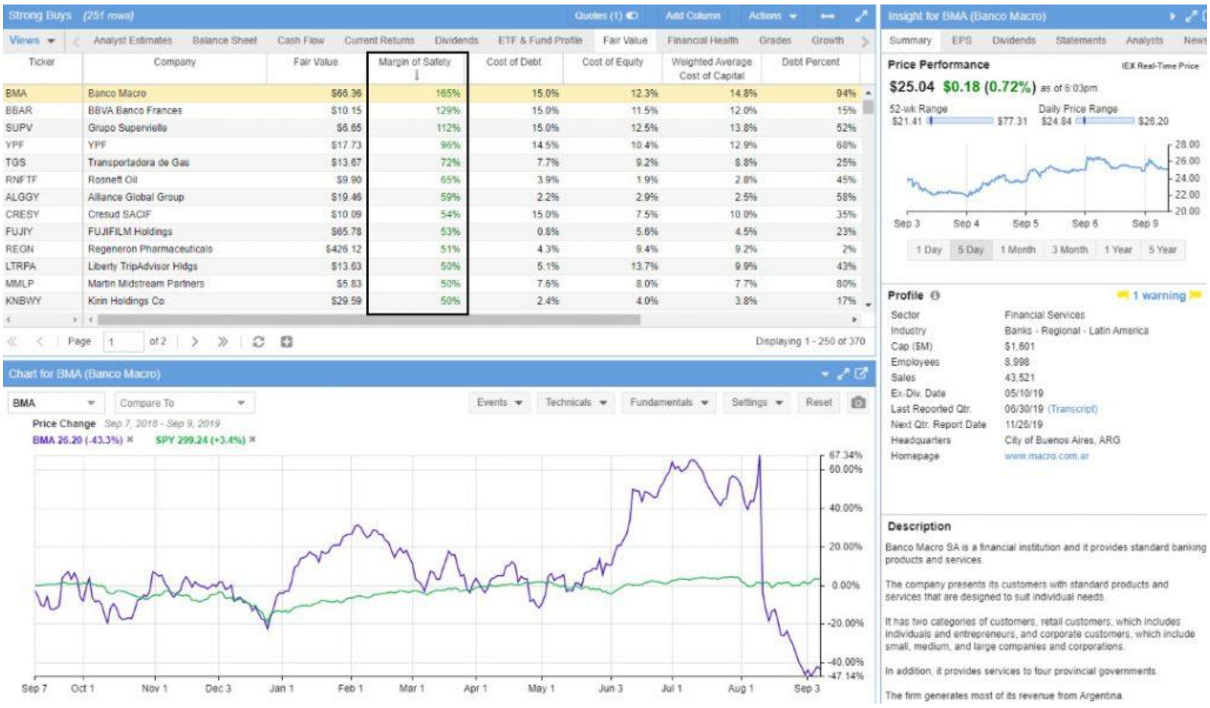
Warren Buffet describes the Margin of Safety like this:

"If you understood a business perfectly and the future of the business, you would need very little in the way of a margin of safety. So, the more vulnerable the business is, assuming you still want to invest in it, the larger the margin of safety you'd need. If you're driving a truck across a bridge that says it holds 10,000 pounds and you've got a 9,800-pound vehicle, if the bridge is 6 inches above the crevice it covers, you may feel okay; but if it's over the Grand Canyon, you may feel you want a little larger margin of safety…"

The **Margin of Safety** is the percentage difference between a company's Fair Value and its actual stock price. This metric the single most significant valuation metric in our arsenal as it is the final output of detailed discounted cash flow analysis.

A person who pays $300 per share in a company with a low intrinsic value of $200 per share takes a big risk. Somebody who pays $25 per share in a company with a high intrinsic value of $50 per share is taking much lower risk.

In this case, the Margin of Safety is 50%.



Stock Rover – Fair Value & Margin of Safety Indicators Automatically Calculated

The Margin of Safety Calculation

Margin of Safety = (Intrinsic Value Per Share – Stock Price) / Intrinsic Value Per Share.

Margin of Safety: (50-25)/50 = 50%

Another name for the margin of safety is the break-even analysis. The break-even analysis is the share price at which you can begin making money from a stock.

Ben Graham and David Dodd created the term “margin of safety” in *Security Analysis*. Today the Margin of Safety is one of the key concepts of value investing.

All value investors need to understand that the margin of safety is only an estimate of a stock’s risk and profit potential. There are many risks that fundamental analysis cannot estimate, including politics, regulatory actions, technological developments, natural disasters, popular opinion, and market moves.

The margin of safety you use is the level of risk you are comfortable with. If you are risk-averse, you will want a high margin of safety. A risk-taker, however, could prefer a low margin of safety.

Fundamental Analysis

They call the most common method value investors use to value a company “fundamental analysis.”

Classic fundamental analysts examine the qualitative and quantitative factors surrounding a company. Those factors can include economic conditions, finances, market conditions, the political environment, the regulatory environment, technology, and the industry’s overall state.

Fundamental analysis seeks to ascertain the risks a company is taking and it’s capacity to make money. Both value and growth investors use fundamental analysis.

Value investors focus on a company’s ability to make money. Growth investors look at a company’s capacity for future growth and stock price appreciation. A value investor could look at the company’s cash flow, while a growth investor will examine its research and development, sales growth, and earnings per share (EPS) growth.

To understand value investing, you need to have a good grasp of fundamental analysis, intrinsic value, and margin of safety. Not all value investors use these concepts. Buffett will occasionally purchase stocks he likes, even if the market price exceeds the margin of value.

Investors need to understand these concepts are theoretical guidelines and not concrete rules. There will be many stocks that make money but violate some value investing concepts.

9 Ways to Value a Company

There is no universally best method of valuing a company in value investing. Value investors, instead, use a variety of valuation methods.

Some popular methods for valuing a company in the fundamental analysis are listed next.

1. **Book Value –** To a classical value investor, book value is an appraisal of all a company’s assets. A good definition of book value is anything that the company can sell for cash now. Examples of book value assets include real estate, equipment, inventory, accounts receivable, raw materials, investments, cash assets, intellectual property rights, patents, etc. Disney’s (NYSE: DIS) book value includes the land its studios and theme parks sit on. Disney’s book value also includes its vast library of films and TV shows and all the characters and stories Disney owns.

2. **Tangible Value –** Tangible value is the potential value that investors can easily calculate. A good example of tangible value is the market price for equipment or real estate.
3. **Tangible Book Value –** Tangible book value or tangible equity is a measure of a company's value that excludes all intangible assets. Tangible book value could include only physical assets and cash investments.
4. **Intangible Value –** A company's intangible value is the money it could theoretically make from assets. Intangible assets can include patents, trademarks, business plans, strategies, customer goodwill, fictional characters (in the case of Disney & Marvel), franchises, and research and development capabilities. A good rule of thumb is that an asset is intangible if there is no guarantee it will make money.
5. **Enterprise Value –** The enterprise value is the total value of the company, including market capitalization. Enterprise value is the price another company could pay for a corporation. A classic formula to calculate enterprise value is market capitalization plus assets plus cash and equivalents minus debt.
6. **Franchise Value –** The franchise value is the value of a company's name or reputation. The idea is that a good name or reputation will increase a company's value, sales, and cash flow. Apple has a high franchise value because of its reputation for making dependable, innovative, and high-quality products. This enables Apple to charge higher prices and sustain high-profit margins while maintaining a loyal customer base.
7. **Dividend Value –** The dividend value or yield is the amount of money investors can make from a company's dividends. They usually calculate dividend value by subtracting the annualized payout from the share price. The annualized payout is the

amount of dividends generated by a share of stock in the past year.

8. **Negative Enterprise Value –** A company has a negative enterprise value when the cash on the balance sheet exceeds its market capitalization and debts. Value investors look for negative enterprise value because it is a sign that Mr. Market is undervaluing a company.
9. **Net Current Asset Value Per Share (NCAVPS)** NCAVPS was one of Benjamin Graham's tools for valuing a stock. You calculate the NCAVPS by subtracting a company's total liabilities from its current assets. Graham considers preferred stock a liability. The idea is to learn how much money a company will have left after it sells all the cash assets and pays all obligations.

There is no perfect method for valuing a company. Most value investors have a favorite method, but their choices often reflect preferences or prejudices rather than results.

It is best to test and use all the methods and find the one you are most comfortable with.

Value Investing Strategy

Value investing is ultimately a matter of strategy. Thus, we can think of value-investment masters like Buffett and Graham as strategists.

Buffett's strategy is to look for growing, high-quality companies that generate large amounts of cash. The Graham strategy is to seek stable low-priced companies that generate lots of cash.

Graham and Buffett ultimately diverged a little in their strategies. Graham’s strategy was one of diversification, buying several stable stocks to create a high margin of safety.

Buffett uses a concentration strategy in which **Berkshire Hathaway (NYSE: BRK.B)** buys as much of a good company’s stock as possible, preferably to own the company outright. Buffett considers cash flow, growth, and the margin of safety important. Graham considered the margin of safety as the most important aspect of value investing.

In the Buffett strategy, cash flow is a tool for growth. A cash-rich company can afford to upgrade its technology, expand into new markets, develop new products, increase marketing, and borrow large amounts of money. Thus, a cash-rich company is more likely to grow.

One of Buffett’s conclusions is that a company is not safe unless it is growing. Buffett designed the strategy of buying growing companies to ensure growth and cash flow.

Graham designed his strategy to create a wide margin of safety by spreading the investment over many stocks. The Buffett strategy generates cash by concentrating investment in cash-rich companies.

Dividend Value Strategy

Dividend value is used by both Graham and Buffett because it ensures a steady flow of cash. The difference is that Buffett and Graham use the dividend value differently.

Graham strategists view a high dividend yield as a means of increasing the margin of safety. Buffett strategists see the dividend yield as cash they can use to fuel future growth.

Franchise value is key to the Buffett strategy but ignored in the Graham strategy. Buffett will pay more for companies with strong franchises because he thinks strong franchises make more money.

Graham strategists view a company’s share price as a more important metric than the franchise value. In the Graham worldview, the share price can tell you if a company is overpriced or underpriced.

Graham strategists think of share price as a measure of the margin of safety. In the Graham world, the higher the share price, the smaller the margin of safety.

Under the Buffett worldview, the share price has no relation to the company’s true value. Buffett thinks of the franchise value as a better indicator of a company’s true value. In Buffett’s world, the higher the franchise value, the more money the company can make.

The Strategy of Market Irrationality

Both the Buffett and Graham strategies try to capitalize upon market irrationality.

The basis of Graham’s strategy is the idea that the market often grossly under prices good stocks. A popular view of Graham investors is that investors pay less for stocks they dislike and boring stocks.

Another of Graham’s ideas is that investors pay more for stocks they like, even if those stocks make less money. Modern value investors use the slang of sexy and unsexy stocks.

Value investors believe people pay more for attractive or fashionable or “sexy” stocks. Therefore, many value investors look closely at unattractive, boring, and unfashionable, or “unsexy” stocks. These people seek good stocks that the market does not appreciate.

A Graham value investor could buy an oil company instead of a tech stock, for instance. The oil company is old-fashioned, boring, and offensive to some people, but it makes money. The tech company is attractive and flashy, but it could make no money.

Market irrationality partially explains Graham’s question of: “does it make money?” Graham investors often look at the balance sheet and ignore the business.

Buffett thinks that popular opinion and the media create market irrationality. Buffett watches the news and looks for bad news about good companies.

The idea behind this strategy is that news reporting is usually shallow, superficial, and concentrated on one aspect of a company’s business. Buffett will sometimes buy companies after a well-publicized scandal.

Berkshire Hathaway (NYSE: BRK.B) kept large holdings of the banking giant Bank of America (NYSE: BAC) despite a scandal at that company. The public turned on Bank of America after news reports alleged some of its employees were writing fake loans to get commissions.

Buffett kept Bank of America because the bad loans came from one small piece of Bank of America’s business. Buffett’s hope was that the bad news about Bank of America would fade over time, but the company could keep making money.

Another key idea in Buffett's market irrationality strategy is that the media does a bad job of reporting on companies. Buffett bets that most news about companies will be inaccurate, limited, short-sighted, biased, and incomplete.

Buffett tries to capitalize on that lack of information by having more information than the rest of the market. Buffett reads financial reports; instead of newspapers and blogs because he thinks financial data gives him an edge over other investors.

Buffet assumes that most investors do a poor job of valuing companies because they rely upon inaccurate media reports. Uncle Warren's strategy is to find more accurate information and base his decisions on that information.

Diversification Strategy

The most popular value investing strategy is diversification, which they design to create a high margin of safety.

Diversified investors assume most people make poor stock choices. The diversified investor tries to counter the poor stock choices by buying various stocks that meet his criteria.

A diversified investor who seeks dividend income will buy high-dividend yield stocks in several industries in an attempt to create safer cash flow. A diversified investor who seeks franchise value will buy stocks in companies with high franchise values.

Buffett buys a variety of growing cash-rich companies to create high cash flow. Buffett's hope is that Berkshire Hathaway (NYSE: BRK.B) will always generate some cash from its many businesses.

Understanding the strategy is the key to learning value investing. All good value investors are good strategists. The ultimate goal of a successful value investor is to design and implement a successful value investing strategy.

Simplifying Value Investing

The fact is, it is great to learn and understand the history of value investing, and grasping the concepts allows you to decide if you want to be a value investor or not.

The truth is that today value investing and dividend investing are a lot easier due to the power of the internet and web-based service providers that do the hard work and calculations for you.

- Stock Rover – Review Winning Value Investing Stock Screener

Excel spreadsheet calculations are a thing of the past as serious compute power enables you to scan for your exact value investing criteria in seconds across an entire stock market you find your potential new investments.

From our thousands of hours of testing, there is only one choice for value investors Stock Rover, winner of our Best Value Investing Stock Screener Review, and joint winner of our Top 10 Best Stock Analysis Software Review.

Powerful Value Stock Screening To Build Your Portfolio

We have a number of practical guides written and tested to enable you to follow a few simple steps to begin to build your value portfolio.

Value Stock Screening Strategy & Practical Steps

4 Easy Steps To Build A Buffett Stock Screener

1. **Understand What Financial Metrics Buffett Looks For In Stocks**
2. **Implement Those Metrics Into A Stock Screener**
3. **Understand How Buffett Evaluates The Business & Industry**
4. **Select The Stocks From Your Screener & Invest In Them**

Dividend Stock Screening Strategy & Practical Steps

Our guide to building a great dividend stock screener highlights to following six steps.

6 Simple Steps To Build The Best Dividend Stock Screener

1. **Select Your Dividend Stock Screener Software**
2. **Choose Your Dividend Investing Strategy**
3. **Select or Build Your Dividend Screener**
4. **Investigate & Select Dividend Stocks for Your Watchlist**
5. **Perform Further Deep Research & Comparisons**
6. **Purchase Stocks & Maintain Your Portfolio**

The Advantages of Value Investing

Long-term Proven Success

The biggest advantage of successful value investing is the capacity to make solid profits over time. Market data shows how Warren Buffett uses these advantages at Berkshire Hathaway (NYSE: BRK.A).

The proven fact is that the stock market has never in its history lost money over any 20 year period, according to the Liberated Stock Trader's Stock Market Statistics.

Sometimes, value investments can lead to dramatic revenue growth. Berkshire Hathaway's annual revenues grew from $81.66 billion in 2005 to $251.44 billion in 2018, Macrotrends estimates. This is a 17.5% average annual growth.

The revenue growth paid off for Berkshire Hathaway's shareholders in the form of astounding growth in Market Capitalization. Berkshire Hathaway's market cap grew from $135.89 billion in April 2005 to $524.22 billion in September 2019. This was a stock price growth of over 20% per year.

Berkshire Hathaway shows value investors can make a lot of money if they have patience. There are other advantages to value investing that make it worthwhile even if you do not make a lot of money.

Those advantages include simplicity, cash flow, and margin of safety & lower transaction costs.

The Simplicity of Value Investing

People often ignore one of value investment’s greatest advantages. That advantage is simplicity.

The complexity of many investment systems can frighten even intelligent people away from the markets. Classic value investing systems like Graham’s and Buffett’s, however, are easy to understand.

They base most value investing systems on a few simple principles, which makes it easy for ordinary people to grasp those strategies. Almost anybody can understand Graham’s rule, one “Does it Make Money?”

Plus, Graham concepts like Mr. Market successfully teach investing philosophies to ordinary people. The Mr. Market character is an insane salesman who sometimes peddles a new Porsche for $100 and occasionally tries to sell junk cars for $100,000.

Through Mr. Market, Graham teaches that the market is irrational and impossible to comprehend. Yet Graham shows how anybody can take advantage of Mr. Market’s lunacy.

People who observe Mr. Market can find bargains and make money. Using a simple system means there is less that can go wrong.

Buffett also uses simple stratagems anybody can understand. Buffett famously refuses to invest in any company or instrument he does not understand. Berkshire Hathaway did not start investing heavily in tech stocks until recently, for instance. By using this rule, Buffett avoids unknown risks and steers clear of markets beyond his expertise.

The Cash Flow

The second advantage of value investing is the emphasis on cash. Value investors may sometimes make less money than speculators, but they are more likely to have cash in their pockets, e.g., generated from Dividends. Also, speculators are essentially gambling, and that means that the risks are higher, and they are more likely to wipe out. Long-term value investors usually always win.

Cash is real money, the money you can spend. Cash flow is a measure of the amount of cash a company runs through its business.

Monitoring a company's cash flow shows you if the corporation is making money.

By comparing the cash flow to metrics like debt, expenditures, revenues, net income, and operating income, you can see how much money the company keeps. Persons who watch the cash flow can spot cash-rich businesses and take advantage of them.

Watching cash flow can help you avoid buying into companies that make a lot of revenue but retain little cash. Companies with a lot of revenue but little cash often have high expenses and lots of debt. Those companies often fall into the death spiral because they run out of cash.

Margin of Safety

Most value investors emphasize the margin of safety. This means value stocks can be safer than other stocks.

Value companies are more likely to have cash, which means they are less likely to collapse during economic downturns. Some value companies can expand and grow in a bad economy because they have the cash to buy ailing competitors.

There is no such thing as a safe investment, but the margin of safety provides an extra layer of protection. You can enhance that layer through diversification.

The margin of safety can make value investments a better choice for average inv who have little extra money.

Lower Transaction Costs

Many people forget that when adopting a long-term value investing strategy, you lower your costs or “leakage.” For example, a speculative day trader will be buying and selling stocks daily, if your broker charges you $5 per trade, and you buy and sell three times per day, you may incur transactional costs of $6,000 per year. If you are a value investor with ten stock holdings and you buy and sell half of your holdings once per year, you will only have transactional costs of $50. This means you would have $5,950 more to invest.

The Disadvantages of Value Investing

There are some serious risks to value investment. Value strategies can limit your moneymaking capacity and increase some risks. Plus, some value investors can get overconfident and miss both opportunities and dangers in the market.

Many value investors miss out on profitable stocks by sticking to their strategies. Warren Buffett calls himself an “idiot” for not buying shares of Amazon (NASDAQ: AMZN) years ago, The Associated Press reports.

Buffett refused to buy Amazon until 2019 because it did not meet his value criteria. By failing to buy Amazon before 2019, Berkshire Hathaway missed out on vast amounts of share value. Amazon's market cap grew from $13.57 billion in April 2006 to $884.52 billion in September 2019, Macrotrends estimates.

Buffett still made money from his other investments, but he could have made more money had he owned Amazon. By being risk-averse, Buffett cost himself and Berkshire Hathaway shareholders' money.

The greatest disadvantages to value investing are those that can destroy any investor. Those weaknesses are overconfidence and complacency.

Many value investors make the mistake of thinking their holdings are immune from market forces and totally ignore the market and news. This mistake can hurt you in two ways. First, you can miss opportunities in the market, like new businesses or sexy stocks. Second, market forces and competition can destroy the value of even the best stocks.

The Value Trap

Complacent value investors often fall into the value trap. The value trap is a stock that looks like a great value investment on paper but is not.

An example of a value trap is a company with high cash flows and shrinking revenues. The shrinking revenues show the company's business could be dying, but the cash attracts value investors.

The company could have a high cash flow because management refuses to modernize equipment, develop new products, undertake research and development, expand into new markets, or market its products. This means there could be no opportunities for growth. The company is relying on older markets, which could shrink.

The value trap springs when the company’s cash flow shrinks. In extreme cases, the company can suddenly run out of money and collapse.

Other examples of value traps include companies with lots of assets and shrinking revenues. Such companies can have high cash flows because management is selling assets or borrowing against assets. Most value traps have a low share price. However, Mr. Market can overvalue the cheapest stocks.

A classic value trap can be an older company with a lot of franchise value. Such a company can be a value trap if management does not take advantage of the franchise. Management could fail to introduce new products, or enter new markets, for example.

The value trap springs because investors become overconfident in their ability to see the value. No value investment is permanent or perfect. Many value investors forget that because they think their strategy is bulletproof.

Final Thoughts

Value investing is still one of the best stock market investing strategies for independent investors. Value investing, however, is not foolproof. You can fail at it and lose money. Only those who do the hard work needed to understand value investing can make money at it.

Only those willing to make the commitment to do the work and study needed for successful value investing should attempt it.