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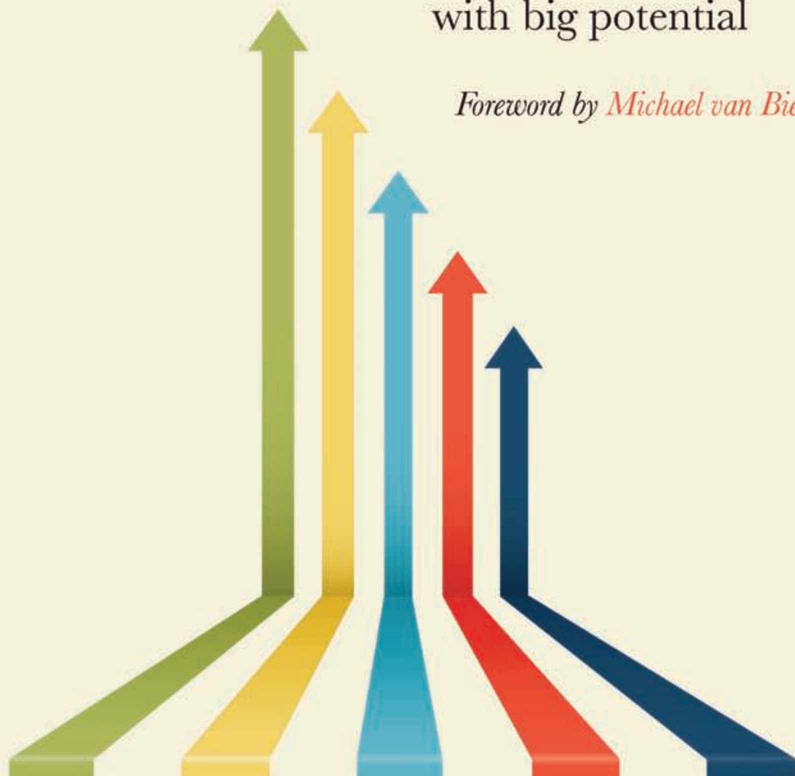
Deep *Value* Investing

Jeroen Bos

Finding bargain shares with big potential

Foreword by Michael van Biema



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DEEP VALUE INVESTING

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DEEP VALUE INVESTING

FINDING BARGAIN SHARES WITH BIG POTENTIAL

JEROEN BOS

FOREWORD BY MICHAEL VAN BIEMA

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This book is dedicated to my father

ABOUT THE AUTHOR

Dutch investor Jeroen G. Bos has lived in England since 1978. He has a diploma in Economics from Sussex University and has worked his entire career in the financial services industry, mainly in the City of London. He worked for many years at stockbrokers Panmure Gordon & Co, and it was here that his interest in value investing developed. This process accelerated after the October 1987 stock market crash, during which time he took inspiration from *The Intelligent Investor* by Benjamin Graham.

At the end of 2003 Jeroen joined Church House Investment Management to manage CH Deep Value (Bahamas), which in March 2012 became the UK regulated Deep Value Investments Fund.

He lives in Sussex, is married and has three sons.

Jeroen Bos holds investments in the Deep Value Investments Fund, Norcon Plc and Record Plc.

FOREWORD BY MICHAEL VAN BIEMA

MODERN FINANCE THEORY postulates a strong relationship between risk and return. Jeroen Bos and his investment style demonstrate the fallacy of this convenient but naive definition of the risk-return relationship. In this book, Jeroen explains how by being a deep value investor one weeds out investments that are both very low in risk and high in return

Jeroen practises a type of investing that I call Statue of Liberty investing – to paraphrase: *give us your poor, your forgotten, your unloved* … [1] The companies he looks into have for the most part either been forgotten by most of the investment community or are actively shunned by them. Lurking, however, in the recesses of this netherworld of the investment universe one finds some equities that represent the

1 A liberal rendition of the actual words that appear beneath that fine lady.

ultimate in value. These are equities whose value is not justified by the future earnings envisioned by the fantasy of management or analysts, but rather by the current facts as presented in the company's balance sheets.

Effectively, what Jeroen teaches us in this book is how to read and think about balance sheets in a simple and very effective way. His goal is to uncover companies and therefore investments where the assets on the balance sheet outnumber the company's liabilities in such a way that the 'risk' of investing in the company's equity is strongly mitigated, and, perhaps more importantly, can be accurately estimated relative to the potential return. The main focus of the book and of the 17 detailed investment examples it contains are so called net-net investments. These net-net investments were first described by Ben Graham who is widely considered the father of both value investing and, in fact, the field of security analysis. A net-net investment is equity where the current assets of the company outnumber all of the company's liabilities. As Graham put it, it is a way of buying a dollar for 50¢.

Jeroen began his value investing career as a broker in London where on his own he developed an attraction for both unloved securities and for 50¢ dollars. As he once told me, he had the ideal personality for this form of investing – being both stubborn and cheap. Joking aside, there is truth to his statement in the sense that great value investors have to both have a nose for cheap securities and then have to be incredibly disciplined in purchasing them only when they are really at value prices.

Jeroen later became a broker to Peter Cundill, the legendary Canadian value investor who generated north of a 17% return annualized over the course of his 33 years career. Peter was a personal friend of mine as well and a member of the board of advisors of my firm. While a kind and generous man, Peter was not a man to suffer fools and his profitable dealings with Jeroen, especially with Amstrad, are a testament to Jeroen's abilities to find investments of interest not just to mere mortals but to one of the super investors of the Graham school.

The book focuses on companies in the service sector since they are better able to rapidly adapt to changes in economic circumstance. Jeroen also stays away from companies that carry any significant amount of debt on their balance sheets, preferring instead to search for companies that are cash-rich.

The companies themselves span a broad cross-section of service industries, from a defense contractor to banking and currency exchange. Jeroen also describes some of his investments in retail and the difficulties associated with investing in that more 'fashion-driven' sector. Some of the investments described here can only be described as legendary. A number are so called three-baggers, but even some of the more modest successes are legendary in the sense that one can buy equity in companies at such large discounts to their value, as Jeroen puts it in the case of Morson group: "one could buy a profitable company with £500m in revenues for less than £20m".

The book is also complete in the sense that it provides a couple of examples of his mistakes and a few where the outcome is still uncertain. Perhaps the most instructive of this the Abbycrest case

study, where Jeroen violates his own principle of staying away from companies with high levels of debt – unfortunately with disastrous results. Two other cases that provide fascinating reading are those of Barratt Developments and Gleeson, both British homebuilders and both of which worked out extremely well, but both of which had quite different risks despite being in the same industry.

Another unique aspect of the book is Jeroen's sell discipline. As he correctly points out, the types of investments he is looking for are not readily available in quantity. They are hard to find and frequently take a long time to 'develop'. Unlike many value investors, he does not necessarily sell when his investments reach fair value; rather, he waits till some earning momentum develops and pushes the share price higher. He, therefore, unlike many value investors, leaves less on the table.

One of the beauties of this type of investing, as pointed out, is that it does not depend on earnings estimates and forward-looking statements by management. These tend to be, not surprisingly, less reliable and far more volatile than the balance sheet. In fact, since most investors depend heavily, if not entirely, on these types of estimates, income statement investors create the price volatility of which Jeroen and other balance sheet investors are able to take advantage.

It takes a few characteristics to be a great value investor. Some of the things we look for at our firm are:

- a focus on the long term
- a willingness to take a contrary view
- patience
- discipline.

As you read through this book, think about how Jeroen and the investment cases he describes display these characteristics. It will serve you well in your own investment career.

Michael van Biema
New York, 2013

Michael van Biema is the former Columbia University finance professor and founder and managing partner of funds of fund group van Biema Value Partners, LLC, based in New York. He is the co-author of the book Value Investing from Graham to Buffett and Beyond.

PREFACE

THIS BOOK FOCUSES on a specific area of value investing, but it happens to be the area that has generated the biggest returns. Deep value investing is a defensive *and* high-potential strategy, picking out companies where it is very hard to lose money even in a worst-case scenario and where genuine potential means an almost unlimited upside when fortunes change. It is as simple as it is sophisticated. Above all, it is about standing apart from the crowd and letting the balance sheet do the talking.

This guide to successful deep value investing is aimed at those investors who are familiar with the stock market, enjoy the investment process, and are interested in generating better returns than the market in general – with a (much) lower risk profile.

It deals with UK-quoted companies, though its principles work equally well in any other country. Crucially, the deep value investing methods revealed here only rely on publicly available information. All the reader needs is an interest in finding investment opportunities that are off the beaten track but have a better-than-even chance of superior returns in the long run. Deep value investing means being happy to look at many different potential investments and choose only the most attractive ones amongst them. Patience is an important part of this process.

> **"All the reader needs is an interest in finding investment opportunities that are off the beaten track but have a better than even chance of superior returns in the long run."**

I have written the book around a large number of investment case studies so as to make the content as practical and well-illustrated as possible. Amongst the success stories there are some investments which had disappointing returns and a few others where the investment has only recently been made. But there is, I believe, just as much to be learnt from these examples as from those where everything went smoothly.

In each chapter I give a short background to each individual company and how and when I found them. I then show exactly how I used publicly available information to build a clear investment case. Every chapter has a freely available online appendix (accessible via **www.harriman-house.com/deepvalueinvestingappendix**) where the

public releases referred to in the chapter have been reproduced in their entirety. This is done so that the flow of the investment case is not buried in endless detail in the chapter, but all the information is there for those who want to take a closer look at what was available at the time.

This book is not meant to provide a mechanical investment approach that can be copied and forgotten. Rather, it aims to demonstrate an entire way of investing that can be adopted (and adapted) by any thoughtful private or professional investor: the logic of why it works, and the application of its principles and techniques to a wide range of real-world shares.

Like all investing styles, deep value investing is dependent on many factors and each individual investment tends to be unique in a number of ways. To quote the title of Richard Oldfield's excellent investment book, like all investing it is inescapably "Simple But Not Easy". Nevertheless, it is my hope that this book marks a significant step towards making this highly rewarding form of investing more accessible than it has ever been before.

Jeroen Bos
London, 2013

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INTRODUCTION: BEING A DEEP VALUE INVESTOR

WHAT YOU CAN GET OUT OF THIS BOOK

THE AIM OF THIS book is to show, step by step, how to find those stocks that have the greatest potential to generate substantial returns. If you are looking to dramatically increase your odds of getting a much better return from equity investing then this book should be of interest.

The methodology described in this book will help you to identify stocks with great hidden potential. Take Chapter 13's Barratt Developments, for instance. At the time of being identified by the methods explained in this book (November 2011), this share traded at 90p. In May 2013 it was trading at 240p – an increase of 270% in under two years.

This book contains many examples of other companies whose shares have shown similar strong price developments – including Record Plc, ArmorGroup International, Harvard International and many more. More than this, it tells you how to find companies like this in future, before their prices explode.

After having read this book you too should be able to generate much better results from your stock market investments by identifying deep value shares at the right time.

FINDING FRIENDLESS COMPANIES

I first started to develop and apply the deep value methodology of this book in the autumn of 1987, after the Black Monday crash, when I worked as a stockbroker at Panmure Gordon & Co. in the City of London.

My early successes in applying this investing approach generated a dramatic and consistent hit rate, discovering great opportunities in companies like H. Young Holdings, Amstrad, Time Products and others. It would take some time before I managed my own fund at Church House, but meanwhile my results improved and I was able to learn how to avoid the kind of real clangers that damage overall investment returns.

My investment approach revolved around a way of analysing stocks differently to most people – I focused on criteria that the majority of equity investors ignored. Stocks I went after tended to have fallen off the radar, no longer had any analyst support, and usually boasted

share price graphs that told a story of enduring disappointment. Their market capitalisation had now fallen and they had become pretty friendless. No one wanted them.

If I could identify solid companies within these kind of stocks ignored by 95% of the market, I had something unique to sell as a stockbroker. This was important because, like all stockbrokers, I was paid on commission.

TEAMING UP WITH A SUPER INVESTOR

But I also wanted to identify a potential group of investors to whom this investment methodology would be of interest. Enter Peter Cundill, a Canadian 'super investor'.

Peter, who unfortunately passed away in 2011, had founded the Cundill Value Fund in the 1970s, and since then had produced investment returns that left the stock market indices in his wake. He would invest on a global basis, usually going to those markets that had had the worst stock market returns that year, as they would have the "biggest bargains available".

I had come across the name of Peter Cundill on the shareholders' lists of many of the undervalued companies that I had found. Having identified Peter as a potential client, I now had to find a cheap company – but also one where his name did *not* appear on the shareholder list. Eventually I discovered such a stock and rang him out of the blue in his office in Vancouver, Canada.

The vast majority of people don't enjoy being cold-called, but I had prepared myself and was confident that I could interest him by mentioning this stock and a few salient points that illustrated its cheapness. Later that day I faxed him a simple spreadsheet on the company and shortly thereafter I was asked to buy this stock on his behalf. This continued with several other small capitalisation stocks until I identified Amstrad Plc in 1990.

A SWEET PICK

At that stage Amstrad was trading at a discount to its cash on the balance sheet, let alone its working capital position. In fact, Amstrad's shares were now trading at such a low level that we would theoretically be able to buy up the company, cease all its operations, pay off all the outstanding charges, and still be left with more cash than we had paid for the shares in the first place.

Amstrad had been floated in the 1980s by its founder Alan (later Lord) Sugar. The company had once been a stock market darling, but when I came across it in the summer of 1992 it had missed several earnings expectations and was something of a fallen angel. The outlook for the company was uncertain. The City was disenchanted with Amstrad and Alan Sugar. The price was exceptionally low. Sugar was at that stage still the largest shareholder in the company.

I rang Peter Cundill to tell him about Amstrad. Not long after this conversation, Peter decided to build a declarable position in the company, months before Alan Sugar attempted to buy the company back at 30p (a potential 50% return). Sugar's plans were voted down

and the shares recovered, reaching a high of 146p in 1993 and 220p in 1994. The company was eventually taken over in 2007.

With his connections in the City, Peter was able to generate some media interest in his dealings in Amstrad and as a result got written up in a few newspaper articles at the time.

This was all well and good – my firm did the majority of the share-buying, and that was my reward for finding the investment opportunity. But it made me think for the first time that at some stage I would like to run an investment fund on these principles myself.

From there to me running the CH Deep Value Investments fund is a long story that we can cut short. It was my good fortune that a friend of mine, Mark Henderson, introduced me in 2003 to James Mahon, the CIO of Church House Investment Management. James, a good value investor himself, immediately grasped my approach to value investing.

He gave me the opportunity – and the rest, as they say, is history.

PART I. THE DEEP VALUE PHILOSOPHY

CHAPTER 1. DEEP VALUE INVESTING

A NEGLECTED METHOD

DEEP VALUE INVESTING has been around for a considerable amount of time, its investment results have been astonishing and still the majority of equity investors ignore its principles and follow a whole host of other approaches.

Why?

Deep value investing, at its simplest, is where assets are purchased at a deep discount to their real worth. This can require a good deal of patience. It takes time to find the right company, and it takes time for the company to come good.

So deep value investing is not conducive to buying no matter the investing climate. Nor is it about being a 'busy' investor. There is a whole advisory industry bound up with the stock market – firms and individuals whose main purpose is to advise clients on their investments. Unfortunately, this industry is structured in such a way that a lot of its income is generated on a transactional basis. This inevitably leads to a

higher turnover of positions than is really justified – certainly than is conducive to a genuine value investing approach.

Investors are given wide access to opinion makers, surrounded by pundits' latest views and market calls, while companies are encouraged (even required) to update investors on an ever more frequent basis. Without necessarily realising it, investors' horizons are being constantly foreshortened. Short-term disappointments are seen as a reason to up and sell and look for better investments elsewhere.

This type of investment behaviour is closely associated with the market's fixation on earning prospects, now and in the near future. There is no escaping the commentary generated by the focus on these earnings. It gains wide coverage and inevitably influences share prices. Stocks get bought up till they reach levels where they are 'priced to perfection'; the slightest earnings disappointment is then punished with a weaker share price.

At the same time, other stocks get bought because they have underperformed others in the same sector and are therefore relatively cheaper. But this perceived value is not based on actual asset values.

Market noise like this drowns out actual facts. But this is also the deep value investor's opportunity: it means you can find hidden gems that everyone else has missed. In fact, you can find them just as everyone else is busily throwing them away.

BARGAIN ISSUES: TRUE DEEP VALUE

There are different kinds of value investing and not all are created equal. Seeking the stronger rewards of deep value investing means not settling for spurious value stocks.

After all, it is perfectly possible to find statistically cheap stocks that are nevertheless remarkably poor investments. Comparing a stock's price with its net asset value (NAV) is an important first step, but it does not tell you all that you need to know. A company's net assets may comfortably exceed its stock market capitalisation, but the nature of those assets can complicate things. Tweedy, Browne – a famous New York-based value investment company, workplace of Walter Schloss and broker to Benjamin Graham – found just this in its highly recommended study 'What has worked for us in investing' (**tinyurl.com/tweedybrowne**).

Many stocks merely trading at a discount to their NAV are undoubtedly cheap, but they often tend to be undoubtedly unexciting. They have gone through years of declining profitability, contracting markets and little hope of a sustained turnaround. Their balance sheets tend to be light on working capital but heavy on fixed assets, where a lot of value is locked up in (obsolete) plant and buildings. They often mention, in the notes to the accounts, that there is surplus land available for sale etc.

Statistically they are cheap. But, crucially, it is difficult to see how the gap between the net asset value and share price can be closed. Often in these cases the NAV eventually joins the share price as losses continue to accumulate and the margin of safety slowly but surely evaporates.

This is obviously not a type of value investing that is particularly attractive. The trouble with this type of discount-to-net-asset-value investing is that one invests in seemingly cheap stocks but they are actually not cheap at all. The nature of fixed assets, as the name implies, is that they tend to be illiquid and for that reason difficult to shift. Surplus land can be sold, for instance, but this can be quite a lengthy process, taking many years to complete, with many unknown obstacles along the way which could derail the whole process at any time. It is all very well that a lot of value seems to be there, but how can it benefit the investor?

And that is exactly why so many 'heavy fixed asset' stocks are, on the whole, not really good investments at all. Interestingly, Tweedy, Browne found that a more reliable indicator of an investment with potential is a share trading at a discount to its *working capital*.

BENJAMIN GRAHAM AND BARGAIN ISSUES

Assets, then, are all well and good – but *liquid* assets are what we're really interested in. The thinking of investing legend Benjamin Graham helps move us towards the full picture of what deep value investing involves.

In 1987, when world stock markets crashed and equity investing went through some very dark days, somebody mentioned to me that it was the ideal time to re-read Benjamin Graham's *The Intelligent Investor*. In fact, I hadn't yet read it for the first time, so I made a note to buy it. Once I started reading it, I knew I had found the fuller investing framework I had been looking for.

Having experimented on my own with value stocks, I could read balance sheets. But with the help of this book a whole new world opened up to me. I read the book in no time and have re-read it many times since. I find it particularly useful when the market goes through a difficult time and stocks don't react in ways that we expect – when everything is being sold off, the good and the bad, and the future of equity investing itself is being called into question.

It is actually at such a time that the value investor should be at his or her most active. However, it can be a pretty lonely place for the stock-buyer. *The Intelligent Investor* is a much-needed source of sanity and support in such moments. It continues to make perfect sense.

Benjamin Graham's classic really taught me *what* to look for in a balance sheet and how different assets affect the attractiveness of potential investments. The most attractive companies, according to Graham's results, are the so-called 'net-nets' or 'bargain stocks'.

The beauty with these value stocks is the prominence of their *current assets*. In the first instance, their fixed assets can be ignored completely. By prioritising shares with healthy current assets, you find shares whose value can be readily unlocked. Current assets are by their nature a lot more liquid and for that reason can be sold off quicker than almost any kind of fixed asset.

If we can find a stock whose current assets (i.e. inventories, receivables, cash etc.) minus its total liabilities are worth more than its current share price in the stock market, than we can talk of a stock that is trading at a discount to the net-net working capital position.

To put it a slightly different way, this is where the current assets minus current liabilities but also minus the long-term liabilities are *still greater* than the current market capitalisation. If that is the case, then we know on a statistical basis that we are dealing with a truly cheap stock. Even if it can never be sold off at a vastly improved share price, you still have a bargain on your hands. The assets are worth more than what you've paid for them.

The icing on the cake is that we have not taken into account any fixed assets. They effectively can be said to come free at the price paid.

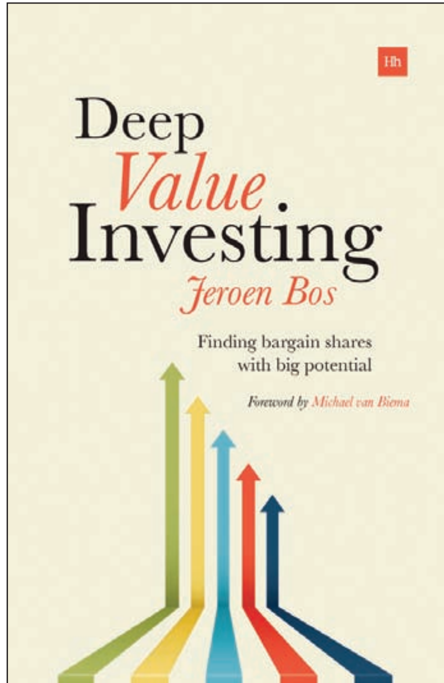
These stocks are known as bargain issues. It is finding this kind of share that this book will focus on, as they consistently boast the highest returns. There are never that many. They can be elusive. They tend to appear, as Benjamin Graham nicely put it, "when Mr Market goes through one of his periodic depressive moods" – when stocks are being sold off with no regard to any underlying values.

But they are always out there; you just have to know where to find them.

Deep Value Investing

Finding bargain shares with big potential

Jeroen Bos



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