



Value Investing in the Age of Intangibles

Two top managers take stock of the industry and the opportunities.

MORNINGSTAR CONVERSATION

Tony Thomas

What's the state of value investing? It's a perennial question, but it has gained new interest after the death of famed value investor Charlie Munger and the renewed dominance of growth investing over the past year.

I spoke with the chief investment officers of two shops that exemplify the best of value investing today: David Hoelt of Dodge & Cox and Bill Nygren of Harris Associates. The conclusion: Value investing is alive and well.

Hoelt and Nygren noted where they dare to differ from Munger and how they've evolved as value investors. They also mused on the state of active management and the future of mutual funds. Our conversation took place on Feb. 28. It has been edited for length and clarity.

Tony Thomas: Let's start with this Charlie Munger comment from the 2023 Berkshire shareholder meeting: "I think value investors are going to have a harder time now that there are so many of them competing for a diminished bunch of opportunities. My advice to value investors is to get used to making less." Do you agree?



David Hoelt, chief investment officer and investment committee member at Dodge & Cox.



William C. Nygren, partner, chief investment officer, and portfolio manager at Harris Associates.



Bill Nygren: It gives me great pause to say I don't agree with Charlie on something. If the statement is that investors need to get used to making less, I can go along with that. The S&P has been going up significantly more than earnings growth plus dividends, and I don't think it's fair to expect that to continue. So, I would say both value and growth investors should be expecting lower returns.

But I would object to the first statement, that we have a larger pool of competitors than we've ever had. I think there are fewer value investors today than at any time during my career. Almost everyone other than my esteemed fellow panelist incorporates momentum into their purchase and sale discipline to some extent. That means that when the stocks start going down, they can go down farther than they used to. And I would suggest the "bunch of opportunities" is not diminished relative to my 40-plus years of doing this. There might actually be a larger subset of the market today that looks unusually cheap than there has been most of the rest of my career.

David Hoefl: You want to choose the places that you disagree with Charlie Munger very carefully, but I do disagree here. I think the valuation spread between the expensive and inexpensive stocks in the S&P is exceptionally wide. As an initial condition, that makes the prospect for value investing over, say, a period of five or 10 years very bright.

If you look at the Russell 1000 Value today, it's cheaper relative to the Russell 1000 Growth than it has been for nearly 90% of the time since the late 1990s. That's our estimation based on different valuation metrics. That bodes well for value outperforming growth. The Russell Value has outperformed the Russell Growth for every five-year period when the valuation spread has been wider than the 80th percentile.

I would also mention that there's a big difference between value stocks and value investing. If you just go out and buy a Fama-French value stock basket defined as stocks with very low price/book or even a very low P/E, that methodology is likely not going to be successful. I think that's

part of what Charlie was pointing to. But value has migrated. Compared to 30 years ago, the ratio of intangible to tangible assets of the collective S&P 500 is up over 3 times, and more than 10 times for tech companies. So, if you narrowly define value as low price/book stocks, that isn't likely to be a viable long-term investing strategy if you don't have a more holistic insight into intangibles and other sources of value that may not show up directly on the balance sheet.

Value Evolves

Thomas: You both work hard to educate shareholders about your firms' approach to value investing. What does value investing mean to you?

Nygren: To us, value investing is paying a price that's a significant discount to the business value of the company. To David's point, for probably too long, most of our competitors defined business value based on price/book or P/E ratios. At the beginning of my career back in the '80s, that worked decently well because it was a more tangible economy back then.

But the problem is that GAAP accounting takes pride in its conservatism. If you can't touch or feel something, the accountants believe it doesn't belong on the balance sheet. Consider an auto-parts company building a new plant expected to last 20 years. It goes on the balance sheet, and you depreciate 5% of it a year to try to match the cost of that plant to each year's flow of revenue. But if I spend money today on customer acquisition costs and I expect that customer to be with me on average for 10 years, that goes straight through the income statement. It's a growth expenditure, but it's immediately expensed. Brand advertising, research and development—straight through the income statement. And these expenditures have become so much more important today as we've gone to a more information- or knowledge-based economy.

There have always been stray examples of companies that GAAP didn't do justice to. Early in my career, it was the cable-TV companies—they had negative income each year, negative book value, yet there was a consistent flow

of going-private transactions. Why? Because the accountants made customer acquisition costs an immediate expense of the business, even though the cable customer tended to stay for a very long time. They had a relatively quick write-off of wires that were in the ground, even though useful lives lasted for a very long time. When you adjusted for that, you could see why private equity firms were willing to pay 10 times cash flow for cable companies.

We had examples of that in our portfolios in the '80s, but it was one or two names out of 50. Today, there are probably 10 to 15 names in the Oakmark Fund [OAKMX](#) that are not going to look cheap on book value or P/E. You have to dig into it, make adjustments for growth investments, for the cheapness to jump out at you.

It's important to educate our shareholders and potential shareholders so they don't look at the portfolio and say, "They're not value investors because Alphabet [GOOG](#) was a big holding for them." Alphabet looks really cheap if you separate out the cash, the venture capital investments they're making, and you make an adjustment for that. We think you're buying the search business at a significant discount to the market.

Hoefl: I'll break it into two questions: the "what" question of how our investing principles are constructed to create value for our investors and the "how" question of how that investment philosophy meshes with the firm.

A number of years ago, my predecessor as CIO, Charles Pohl, pulled together an anthology of academic research that focused on the characteristics that distinguish successful active managers. We found that in addition to the expected set of fund characteristics—low expenses, low fees, low trading costs—there were a few other characteristics that were intuitive, but maybe a little bit less obvious. One of them was a high active share with a long-term investment horizon. Another was a collaborative investment process that has teams making decisions. And the third was managers who are aligned with their investors through fund ownership. These characteristics of successful active managers aren't exclusive to value investing,



and they don't guarantee success. But when they're present, they tilt the odds of success in the fundholders' favor. That's the "what."

The "how" we find value is more creative and differentiating. Everyone is trying to assess the same characteristics of a company: growth, profitability, capital intensity, franchise strength, management, governance. The challenge is that you rarely get these with an attractive valuation. To us, value investing means assessing the trade-offs along these dimensions. Whether a company is an attractive investment is driven by the individual dynamics of that company, so you tailor the valuation analysis to it. With pharma, for example, you might start with the valuation, subtract out an estimate of the value of the drugs in production or in the FDA pipeline, and then back into what value the market's ascribing to the R&D. If that value is exceptionally low, it tells you the bar for future discovery is very low. What do you think their probability of success is? What reasons do you have for taking a position different from the market?

At different points over the past 15 years, software companies such as Cadence [CDNS](#), Synopsys [SNPS](#), Autodesk [ADSK](#), Adobe [ADBE](#)—a pretty long list of companies—traded at exceptionally attractive valuations. These companies were shifting from upfront revenue recognition, where you might recognize a multiyear contract in day one or year one, to a ratable business model, where you're spreading out the revenue recognition over multiple years. That transition obscured the true economics of the business.

To Bill's point, were these companies optically cheap by conventional valuation metrics? No, because profitability was depressed by expensing high R&D that legitimately added value, and the revenue recognition was also transitioning, which obscured their profitability and free cash flow potential. But they did offer exceptional value relative to price when you considered how they could monetize this long-term value that they were creating for their customers.

Value investing isn't just about finding companies with cheap prices and valuations. It's also about thinking creatively about the underlying business

value. We want our clients to understand how we invest, to share our long-term perspective, and we think that's key to them being able to stay the course when there's a market drawdown and the opportunities are actually more attractive, so that they are able to benefit from the long-term opportunities that we're uncovering on their behalf.

Thomas: [Under this more holistic approach to valuation, how do you think about when to sell?](#)

Hoelt: We regularly have off-site discussions where we focus on our investment process and how we can improve it. We typically crunch a lot of numbers to generate questions and queue up topics. One of our findings several years ago was that what we refer to as our sins of omission—meaning the things that we did not own, or the things that we had owned but then sold—were far greater than our sins of commission, or the companies we owned that underperformed. This was a consistent finding as we went back in time, so this was not just a byproduct of, for example, being underweight the "Magnificent Seven" or something.

Much of the underperformance was from companies that we sold as valuations were beginning to expand. The question was, why did we sell these companies too soon? One source of the problem is human psychology. It's classic risk aversion to want to sell a stock when you've made a substantial profit rather than stay invested when the long-term investment thesis remains intact. We've done a couple of things to try to balance out that tendency.

We try to explicitly track each component of our investment thesis over time, across companies. We're trying to itemize how our thinking has changed, to be explicit about that as part of our trim/sell conversation. There's no way you can totally inoculate yourself against thesis drift, but this is our attempt to do that.

A second step we're taking is based on analysis we've done that decomposes equity returns into sales growth, margin change, capital return, and change in valuation. As the investment period extends, the contribution from valuation declines relative to the contribution from these

other components of return. That makes sense, since valuation typically has a mean-reverting aspect. Valuation can't grow to the sky.

We typically have our analysts look out three to five years when they're doing their scenario analysis, but our average holding period is a little bit longer than that: seven years. Another question we're asking ourselves before we trim or sell is whether our answer might change if we extend the time horizon. Obviously, no one has a crystal ball, especially one that works that many years out, but it's a good exercise that helps clarify the analysts' conviction. What we're focused on is trying to understand whatever we can about the durability of the business model. How defensible is the moat? Have the conditions of the company or the industry dynamics improved?

Nygren: I like the idea of the off-site meeting with big data dumps on what we've done right and wrong. We may copy that. We've seen in our own history a tendency for analysts to be too anxious to claim a win. You think something's worth \$100 a share. You recommend it at \$60 and set your sell target at \$90. But rarely does a stock go from \$60 to \$90 without there being some new fundamental information. To us, the important thing is to make sure that the analyst has fully incorporated that in terms of a revised sell target and not just sat with their sell target from the day they first recommended the stock.

We found that value investors tend to be conservative when they pitch an idea the first time, and they'll only go out as far on potential P/E appreciation or growth expectations as they need to make the stock look cheap today. We very much focus on trying to make sure we squeeze out all of that conservatism before we actually sell the stock.

One of the things we've noticed in studying patterns in stocks that we've purchased is what I would call fundamental momentum. We don't want to ever respond to price momentum, but companies that start doing better than you expected tend to keep doing better for a while. Analysts tend to underincorporate that change into their estimates. And companies that



disappoint tend to continue disappointing for a while. An analyst might have a knee-jerk reaction to a disappointing quarter: My estimate's down 10%, the stock's down 15%, so it's more attractive today than it was yesterday. But we found that's generally not true, that the analyst has only partially incorporated the negative news into their longer-term outlook. Focusing on trying to make sure that all new fundamental information has been incorporated into our sell targets before we execute on them has been an important change for us, and it has led to somewhat longer holding periods on average.

Another thing we've required analysts to do is what we call a postmortem, for lack of a better term, a year after something gets sold, to put out a note about the fundamentals tracked relative to the fundamentals we underwrote in our sell decision. We often see that we checked out on the idea way before the margin improvement story had completed or the growth improvement story had run its full course. The biggest thing is to make sure you don't stick to an original conservative sell target. Make sure you've incorporated new fundamental developments.

Tailwinds Ahead

Thomas: How favorable are current market and economic conditions to your style of value investing?

Hoefl: In an absolute sense, the market is fairly expensive. It's something like 20 times forward P/E at year-end and still about 18 times if you exclude the "Mag Seven." We probably have even more concern with the market expectations for earnings growth. The '23 to '26 FactSet consensus EPS growth is 12.5% per year. The S&P 500 has not managed to grow earnings that quickly over a three-year period in the last 35 years unless you're starting from a depressed base — and EBIT margins, per FactSet, are 17.5% today, which is very high by historical standards. We're just not excited by the prospect of paying a high multiple on high margins.

But that's when everything is aggregated. The spread of valuation is really wide, and that's where the opportunity is created. The most expensive quartile of the S&P 500, when you tease

it out, has a forward P/E multiple of over 33, and the cheapest quartile is under 11 times. This massive spread is a real tailwind for our style of investing.

You also asked about economic conditions. We're in the preparation business, not the macro forecasting business. While we don't take a top-down approach to investing, we do monitor our risk exposures to make sure we understand where we have macroeconomic factors that could impact portfolio returns. Having said that, we think today that the market seems pretty

confident that there's going to be a soft landing, full employment, lower rates. And that relative unanimity of expectations can create opportunities.

There's a lot of concern over office commercial real estate, in particular, and that's probably justifiable. But has that focus led to punitive valuations on some financials? Have a lot of financials been tarred with the same brush? And is there any insight that we can come up with about the magnitude or timing of office CRE losses that could create opportunities for bottom-up investors like us?



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David Hoefl



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Bill Nygren

Nygren: We, too, don’t have much conviction in our macro forecasts. I’ve been at Harris Associates for 40 years. Our macro forecast for those 40 years has always been that seven years from now will be normal. There are only a couple times that that’s actually made us an outlier relative to other forecasts.

It’s hard to argue the S&P 500 is historically cheap at more than 20 times forward earnings. I think the average over the past 50 or 60 years has been 16 times earnings. But David mentioned how wide the spreads are today, and we definitely

agree. They’re not as wide as they were at the end of the dot-com market in 2000, but they’re just about as wide as anything we’ve seen since then.

Something that we have in our client presentation books for this quarter is a look at how different our portfolio additions were in 2022 compared with 2023. In ‘22, we were adding names like Adobe, when you only had to believe in two years of growth to get to a market multiple, or Uber UBER when it was at a double-digit free cash flow yield. Those opportunities disappeared in last year’s market after growth names rallied so

much. For the names that we added in 2023, the median P/E was 11 times 2024 earnings expectations, while the median for names we sold was 21 times. While we concede that the quality of business we’re buying isn’t quite as good as what we’re selling, we think a gap of nearly 100% on P/E multiples doesn’t make any sense at all.

An analogy that I like: Back in ‘22, we were selling a little less than three shares of CVS CVS to buy one share of Adobe. CVS was at about \$100, Adobe was just under \$300. Then last year, CVS had fallen to \$70, and Adobe had risen to \$450—and we were selling a share of Adobe to buy six to seven shares of CVS. In just a year’s time, the growth name was performing so well and the value name performing so poorly that it allowed us to swap back into twice as many CVS shares as we had originally sold.

The other thing we find unusual is how diversified the portfolio of names in the bottom quartile is today. People think you’re just buying energy stocks and banks, but it’s broadly throughout financials, and it includes consumer staples, a number of healthcare names, industrial technology, the materials space, traditional media. You can build a nicely diversified portfolio today out of the bottom quartile of the S&P 500, and that’s just as unusual as how wide the spread is. We’re very excited about the opportunity for value investors to perform significantly better today than we have over the past decade.

Hoelt: We are finding a fairly rich variety of business models in this discounted neighborhood. Companies are cheap for a reason. For example, Wells Fargo WFC: Concerns about regulation have been hanging over the company for years. But sources of past weakness could be a source of prospective strength. I’m referring to the asset cap imposed on Wells Fargo’s growth as part of the consent decree, which has prevented substantial asset growth late in a credit cycle. As any watcher of financials over multiple cycles would observe, growing assets too quickly at the wrong point in the credit cycle could be hugely dangerous. We think once the regulatory issues are resolved, it’s likely that the opportunity set will expand. And right now, it’s trading at something like 1.3 times price/tangible book. Its estimated



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return on tangible equity for 2024 is 12%. That's a really attractive set of characteristics.

How do we calibrate the risks? Wells has been in the regulatory penalty box for longer than expected, but we do expect that the asset cap is going to be lifted. Also, Wells Fargo has one of the highest office commercial real estate exposures of anything in our portfolio, and we are overweight financials writ large. Our stress test indicates that potential losses might be in the range of 1%–3% of market cap—meaningful, but manageable.

Another one that I'd touch on is [Norfolk Southern NSC](#). A rail system is typically not something that you're going to find on sale. It's an asset-heavy business, but the asset intensity is what provides the moat. It would probably cost north of \$100 billion to replicate the Norfolk Southern network. Just imagining the complexity of trying to permit 19,000 miles of track through the midst of all the cities they traverse is mind-boggling. When we were buying last year, it was trading at a substantial discount to its peers. You might recall the Ohio derailment that Norfolk Southern suffered. In the two or three quarters after that derailment, Norfolk Southern lost relative market cap of about \$10 billion. Our view was that while the accident was tragic, Norfolk Southern was likely to spend much less than that \$10 billion to make things right. And a year later, the bulk of the dollars going toward remediation have been spent, and it appears to be in the \$1 billion to \$2 billion range. That's before any insurance recoveries, which might be material.

Overall, we're finding lots of interesting opportunities out there. Some of them are traditional deep value, and some of them might be considered higher-quality franchises.

Earning Your Fees

Thomas: [Our data shows that total assets in passively managed funds finally surpassed those of active funds at the end of 2023. What are the implications of that?](#)

Nygren: Some of that has been self-inflicted by the active industry. What do you need to do to justify the fee that you're charging? That

has changed over my career. The average person's access to the stock market 50 years ago might have been the neighborhood stockbroker, and that was a very expensive way to access the market. Just offering a fund of lots of big companies and charging 1% for that provided a better deal. Then the index fund came in and said we'll give you that big old diversified portfolio almost for free. And too many active managers clung to the old business model of providing basically a closet index fund, never taking enough risk to risk getting fired from their accounts.

Paying attention to active share and the fee you're charging relative to active share is really important. Our diversified large-cap portfolio tends to have an active share of around 85% relative to the S&P 500. If you look at active share divided by our fee, our fee goes from looking like we're in the upper half of the mutual fund universe to being very low. That's something fund managers need to think about.

Tax efficiency is also something they need to think about. We've seen advisors shifting out of open-end mutual funds to separate accounts because they think they're getting better tax efficiency. Funds that are tax-aware can have significantly better tax efficiency than a separately managed account can. But it's an argument that the fund industry is not spending much time making and is, therefore, losing.

We've also allowed the passive investors to get away with defining risk. If you define risk as how I deviate from the index, Oakmark looks like a very risky fund. Well, we don't think our investors should care how much we deviate from the index. Our investors are trying to grow capital over time. They should care a lot about how far below zero we are in bad years. And we look pretty good relative to the S&P 500 on that metric of risk. But we've allowed the industry to define risk by tracking error and standard deviation of returns as opposed to drawdown risk.

Hoelt: We don't think it's an either/or between active and passive. Clearly, there's room for both. But rising passive assets, we believe, make the role of a successful active manager more valuable, and I'd argue the active task becomes easier.

For example, we've seen a decline in the quantity and quality of sell-side research resources over the last 20, 30 years, and we would connect that to the increase in passive investing. If you have your own internal research team, as we do, and as Harris does, you have a relative advantage today that has only improved.

Burt Malkiel and others have pointed out in recent years that less and less of the movement of a company's equity price—something like 15% less, versus 20 or 25 years ago—is linked to things that are specific to the firm. This increasing disconnect between what's actually happening with the companies and what's reflected in equity prices is consistent with increased passive flows. Passive investors are still making an active investment choice if they go with a passive alternative. It's just that they've outsourced the decision to the index manager who follows what is popular. Growth in passive assets just sets the stage for future outperformance for active managers that have a repeatable investment process that could add value, because the premium grows for price discovery.

There have been too many high-cost, low-performing active mutual funds in the marketplace. This is probably the largest single driver of passive gaining share in the past. But not all active funds are created equal. We look at the net-of-fee performance we have provided for our fundholders over the benchmark and then denominate that by the fee. Over the past 25 years, we've generated about \$4.50 for our clients in returns above that which was generated by the S&P for each \$1 we've earned in fees.

We think there are lots of opportunities to perform well for clients. And we think this mutual fund model has a lot of longevity. The question that prospective fundholders should ask is whether the fund and manager that they're evaluating are capable of generating long-term returns relative to a passive option in excess of its fee. ■■

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SEC Standardised Average Annual Total Returns as of 31 March 2024 (Stock Fund – Class I vs. S&P 500): 1 Year 25.61% vs. 29.88%; 5 Years 13.57% vs. 15.05%; 10 Years 11.08% vs. 12.96%.

Current Prospectus Net & Gross Expense Ratio (%) as of 31 March 2024 for Stock Fund Class I Shares: 0.51%.

SEC Standardised Average Annual Total Returns as of 31 December 2023 (Stock Fund – Class I vs. S&P 500 Index): 25 Years 9.86% vs. 7.56%. The difference between 25-year performance was calculated using the Dodge & Cox Stock Fund net expense ratio as of 31 December 2023.

Stock Fund's Top Ten Holdings as of 31 March 2024: Wells Fargo & Co. (4.3% of the Fund), Alphabet, Inc. (3.8%), The Charles Schwab Corp. (3.8%), Occidental Petroleum Corp. (3.6%), Fiserv Inc. (3.4%), The Cigna Group (3.0%), MetLife Inc. (2.7%), RTX Corp. (2.7%), Sanofi SA (2.6%), Microsoft Corp. (2.4%). Fund holdings are subject to change and should not be considered recommendations to buy or sell any security.

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When considering mutual funds, investors should look beyond historical performance. They should consider factors such as the Fund's investment objective, the types of securities in which it invests, and its level of risk as compared with other types of investments. There are inherent risks associated with investing in the stock market, including possible loss of principal, and investors must be willing to accept them.

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