By Edward K. Riley

INVESTING

Value Investing

A key to convincing investors to think value is getting them to "look down" instead of "up."

The past year's equity-market rebound has encouraged many investors to consider more active investment approaches again, which can be a welcome opportunity for advisors if they can demonstrate value to them.

While many investors are once again excited about entering the market, isolated feel-good stories in the media sow the seeds of irrational exuberance and encourage irrational investment decisions. As an advisor, it's time to yank your clients back to reality and remind them of the importance of value. It's true that a few companies have grabbed the headlines recently, and investors are eager to hear about some winners. But as Warren Buffett notes: "Price is what you pay; value is what you get."

A key to convincing investors to think value is getting them to "look down" instead of "up." Rather than watching the meteors at the top of the market, clients must learn that value exists in the pebbles closer to the bottom.

Volumes have been written on the fundamentals and efficacy of value investing, and it is critical that we teach our clients discipline and patience. Once they learn to ignore the herd's exaggerated optimism, you can help them focus on the business of informed investing: sifting through the pessimism at the lower end of the market and finding value in gems among the pebbles.

Today's markets rely on a tenuous balance of optimism and pessimism. Individual investors can liquidate a basket of stocks in one sector and buy a basket in another, with a single call or click of the button. They can short a sector or basket of stocks without a margin agreement or the threat of a margin call. What this means is that the herd instinct to buy winners and sell losers is as strong as ever, and through product innovation, can now be executed on a level never before experienced. Optimism is driving some stocks to unprecedented valuations while pessimism is driving others to illogical lows.

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Where the bargains are

Most bargains can be found where they usually hide—in small and mid-cap companies with solid financials, entrepreneurial management, sustainable products, defensible market share and potential for growth. Of course, the fundamental analysis and research of traditional value investing is at its most productive when it is combined with patience and discipline.

Another potential breeding ground for bargains is an area few investors associate with value: the fixed-income markets. The perception that bonds are primarily a defensive investment was formed over the course of several decades of bull markets. But view the municipal market with an eye on the current economic environment and it presents a picture that is rife with value play opportunities.

Municipal bonds offer some important positive fundamentals. Municipals currently offer unusually high yields compared with treasuries; the specter of rising taxes serves to increase the value of their tax exemption even more. Similarly, it is possible that an extension of the Build America Bond program may help trigger a refunding boom.

On the other hand, there are potentially negative factors looming in the municipal markets. These include dwindling tax bases due to high unemployment, low housing valuations, foundering sales tax revenues and unfunded municipal pension obligations, combined with the inevitability of rising interest rates. However, even these unfavorable developments could be good news for patient investors as the volatility they generate might spawn additional value opportunities amid the instability.

Over the last 20 years, I have met many clients with remarkable loyalty to their advisor, even in the face of difficult markets. When asked what they really appreciated about their advisor, one answer I frequently heard was: "My broker taught me how to make money in the market." This illustrates the importance of the bond that can develop between investor and advisor.

You can strengthen this bond by educating your clients about the value of value investing, which helps them weather whatever the market throws at them and helps you nurture and protect your relationships. □

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