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# The Theory Behind How Steve Nyvik Invests

*"Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."*

– Warren Buffet

In this article, we'll learn about what is an investment strategy, why we might want to use an investment strategy, why we might specifically want to use a value strategy, and some of the issues to increasing our odds of being successful in using a value strategy.

## What is an investment strategy?

An investment strategy is a method of selecting stocks that possess certain characteristics where a basket of such stocks are thought to deliver better investment results than that of simply buying a stock market index fund.

An analogy of an investment strategy is where one feels they can do better going into an antique collectibles shop and selecting specific items for sale as opposed to buying an interest in all items in the shop. A selection system can be thought of as a way to help us identify the best deals.

## What is an 'effective' investment strategy?

An effective investment strategy is one that is considered to be logically sound and has delivered superior performance. These characteristics must both be there for us to have confidence that future results are likely to re-occur and for us to experience those superior returns. Specifically:

- There must be a rational financial cause and effect relationship that the strategy selection factor has with stock prices. For example, a company whose earnings have been increasing through time will likely see its share price increase over time. That's because a company whose earnings are rising is becoming more valuable. So if all other things are held constant, we should see the stock price increase in value over time. A contrary example is that of buying stocks when it is observed that the hem of most American women's skirts are above the knees. Although this might have been a pattern that has occurred in the past, there is no direct cause and effect relationship and therefore no way to have confidence that this phenomenon will again occur resulting in higher prices.
- The selected factors are found to be statistically significant. In other words, a group of stocks possessing that factor (or factors) in a large enough sample size that is large enough to accurately represent the phenomenon of the entire population of stocks, is found through running this selection method over many time periods (say at least 20 years), to have achieved superior performance which we can conclude was not due to chance.

## What is a 'value' investment strategy?

Value investing is an investment strategy that involves picking stocks that appear to be trading at less than their fair value. Those using such a strategy believe the market overreacts to good and bad news resulting in stock price movements that do not correspond to a company's long-term fundamentals. Through buying stocks trading well below their fair value, they believe those stocks, as a group, will on average, eventually rise in price reverting towards their fair value. Such type of strategy over time is thought to deliver superior returns, which can be at less risk, than that of buying a stock market index fund.

A value strategy identifies stocks that possess value-type characteristics like good dividend yield, low price-to-earnings, low price-to-book value, low price-to-cashflow, low price-to-sales, or low price-to-earnings relative to earnings growth. In effect, the relative value of one stock over another is all in the "eye of the beholder". A strategy can possess a single value factor or it might use a combination of value factors. Different factors or combination of factors will affect the ranking of one stock being more or less favourable than another.

## In human behavior terms, why does value investing work?

People make emotional, logical and analytical errors. These tend to push the price of a stock to levels that are too high or too low relative to its fair value.

Taking advantage of such mistakes often requires decisions that seem to run counter to our "normal" inclinations. For example, it might be best to invest in a company that is unpopular and has been unfairly punished in the markets.

Buying a number of cheap stocks under a value investment style helps you in two ways with regard to the over-reaction phenomenon:

- You avoid the risk that over-valuation creates when people over-react and push a stock to excessive prices; and
- You benefit by buying a stock that has been beaten up. People may have become unduly pessimistic about its future prospects. A company with poor results may eventually turn things around. It might lay off a number of non-essential employees, shed unprofitable product and service offerings, freeze or roll back salaries, invest in research and development to create better products, cut overhead, or become more efficient in delivering its core products and services. At some point, these actions may translate into an improvement in earnings. And the stock may eventually move up towards its fair value.

## Issue of not choosing enough stocks

Part of the power of relying on one or a combination of value factors is that it identifies without bias which stocks have the "best relative value." However, in the strategy model simplicity, it ignores other factors that may also contribute to a stock's value.

Consider a company that produces a sub-standard product (maybe there was a new entrant) and even though based on historical earnings it might look cheap, the company may continue to experience earnings decline and share price decline.

There are a number of scenarios we can imagine where the factors just can't account for the future share price of a company. It is for this reason that we need to buy enough stocks to minimize this company risk so that we are more likely to experience the strategy return.

There is some academic debate on how many stocks it takes under a strategy to be likely to achieve the strategy return. I would argue that we would want to buy at a minimum of 20 stocks.

## Issue of Industry Risk

In practice, when we utilize a strategy, we are likely to find several stocks in the same industry being under-valued. The problem is that stocks in the same industry tend to be correlated and move up and down to a similar degree. So choosing a number of stocks in the same industry does not help to reduce portfolio volatility.

High portfolio volatility is not only uncomfortable for the investor, but if that investor is eating capital to meet living needs, that can mean the investor having to sell stocks when they are down thereby creating permanent losses. And this can result in the portfolio not recovering and running out of money sooner than planned.

So it may be of value to diversify the stocks by industry to lower portfolio volatility. It can also help provide added return where there is then usually an industry doing well and an industry doing poorly so that one can sell a stock at a high value and buy one at a low value.

## Issue of a cheap stock remaining cheap

It can take time for a company to turn things around and for results to be seen. And it can take even more time for investors to become convinced that enough changes have occurred – investors might want to see a few quarters of positive earnings growth before committing more money to buy stock.

The stock could even experience earnings per share increases but investors choose to stay away (the 'once bitten twice shy' phenomenon) and a cheap stock becomes even cheaper.

And there are times when buying value stocks just doesn't work because there is not enough appetite (imagine investors want just the sexy tech stocks that have been moving up) regardless of how cheap some stocks become.

This risk can again generally be managed by buying enough stocks. We might replace a stock with one that is ranked at a much better relative value. But other than that, we want to give the stocks the time for their earnings to improve and for it to be recognized.

## Issue of Terminal Funding

There is an interesting phenomenon where one is retired and drawing money regularly from their portfolio. In this situation, a strategy of high returns can lead to poorer results than a strategy with lower returns but better "risk-adjusted returns".

An example is where one is comparing a stock market index fund to that of a corporate bond pool.

The reason why this result can occur is that in a downturn, if you have to sell stocks to meet your withdrawal requirements, you are making losses permanent and the portfolio may never be able to recover to its pre-drop level. And through time, that regular portfolio withdrawal eats a larger percentage of the portfolio which can lead to running out of money sooner than planned.

So when we think of investing in stocks and are retired, we are normally better off to be invested in lower-risk value style strategies with much better risk-adjusted returns.

## A Twist in Value Style Thinking: A Better Mousetrap

Rather than investing with the mindset of capital gains, a better investment style might be having an income focus. If regular periodic income from your portfolio plus CPP, OAS and other pensions is enough to meet your needs, you don't have to worry if the market goes down. The income still gets generated and your needs continue to be met without touching capital. The result of this is that we have avoided the terminal funding risk issue.

Although we still have a certain amount of income that needs to be generated, we can select those that also have good sustainable businesses. These are likely companies with sustainable competitive advantages, relatively low debt levels, good products and services, and good management.

In essence, we are seeking good "pension payors" and we want to buy at least 20 of these stocks to develop a stable pension and to stabilize our capital.

We would want to buy these stocks directly to minimize costs so we receive as much of the cashflow for meeting our living needs.

And, lastly, we want to hold these investments in a tax-preferred way so we keep as much of the income in our pocket.

## Summary

In building a better mousetrap, we are focused on value investments that generate enough income which provides good risk-adjusted returns. It is a well suited strategy for meeting retirement living needs as income is a more stable and dependable cash generator – in good and bad times – without eating capital. Can you afford the risk of outliving your money during your retirement?

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