Buffett Abandons Book Value

Warren Buffett's recently released annual letter for 2018 was, as always, well worth reading. In a significant shift, Buffett announced that he will no longer begin his letters with a discussion of Berkshire Hathaway's book value per share. Buffett explained,

> "For nearly three decades, the initial paragraph featured the percentage change in Berkshire's per-share book value. It's now time to abandon that practice. The fact is that the annual change in Berkshire's book value… is a metric that has lost the relevance it once had."

Buffett cited several sources for the lost relevance of book value including accounting rules and the impact of share repurchases.

Criticism of accounting treatments is nothing new from Buffett. In last year's letter, he described how accounting rules made net income "useless." In our piece "Accounting For Value in a Changed Economy", we describe a number of the same accounting distortions that Buffett cites and discuss how they have worsened over time with the economic evolution from an asset-intensive to an increasingly asset-light economy. The paper also describes why we use a cash-flow based valuation methodology that is designed to circumvent accounting distortions like the ones Buffett details.

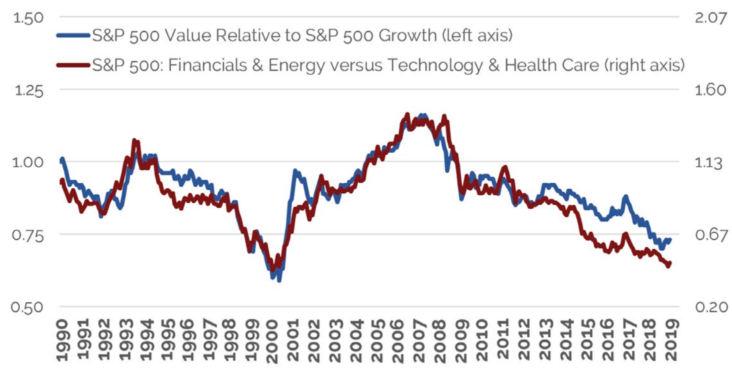
It is extraordinary that the world's most successful investor has abandoned the use of book value and described net income as meaningless when so much of the investment industry is still focused and driven on valuation measures derived from these accounting metrics. Most value indexes, for example, are based either on price-to-book (P/B) alone, as with the Russell 1000 Value Index, or some combination that includes P/B and price-to-earnings (P/E), like the S&P 500 Value Index.

A major result of the reliance on P/B and P/E is that many "value" indexes end up being chronically overweight sectors like financials and energy where accounting rules generate book assets. Those same sectors tend to spend less on R&D than many other "new economy" sectors as well. Consequently, on measures of P/B and P/E, financial and energy stocks may look persistently less expensive than stocks in the technology or health care sectors that have less in the way of traditional assets and spend more on R&D. The impact of this is evident in a chart comparing the performance of the S&P 500 Value Index relative to the S&P 500 Growth Index against the performance of the financial and energy sectors relative to the technology and health care sectors. The value/growth performance tracks almost perfectly with the financial & energy versus technology & health care performance. So, rather than value indexes therefore representing pricing opportunities in the classic sense of Ben Graham, which was the intent, the change in our economy and the related difference in accounting treatments between sectors have left the value indices as simple collections of highly asset-intensive sectors like financials and energy.

Investors in funds that track these indexes or employ similar methodologies and are waiting for a revival in "value" investing are instead getting unintended sector exposures and chronically missing pricing opportunities in other areas of the market.

Due to accounting issues, "value" indexes may be little more than unintended exposures to asset-intensive sectors. The performance of the S&P 500 Value Index relative to the Growth Index closely tracks the performance of the financial and energy sectors vs. tech and healthcare.

Figure 1: Value/Growth Performance vs. Financials & Energy/Tech & Health Care Performance



Source: FactSet

Buffett not that long ago also took issue with another notable industry practice. Volatility was a subject in the Berkshire 2014 letter to shareholders. In it he wrote,

> "…volatility is almost universally used as a proxy for risk. Though this pedagogic assumption makes for easy teaching, it is dead wrong: Volatility is *far* from synonymous with risk. Popular formulas that equate the two terms lead students, investors and CEOs astray."

Since most industry-standard risk metrics depend on measures of price volatility, it is remarkable that the most successful investor in the world describes this norm as "dead wrong." In another paper describing our investment process called "Risk: Fundamentals Over Price Volatility", we detail why we heed Buffett's advice and look at a combination of long-term fundamental stability, leverage, and valuation to assess risk rather than relying on short-term price volatility.

Concluding, we cannot think of many industries where the most acclaimed practitioner has decried the use of commonplace practices in the same way that Buffett has criticized industry norms for measuring valuation and risk. When this commentary is put in the context of ongoing performance challenges for "value" indexes and many "value" practitioners, it is surprising that the underlying methodologies have not garnered more skepticism.

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