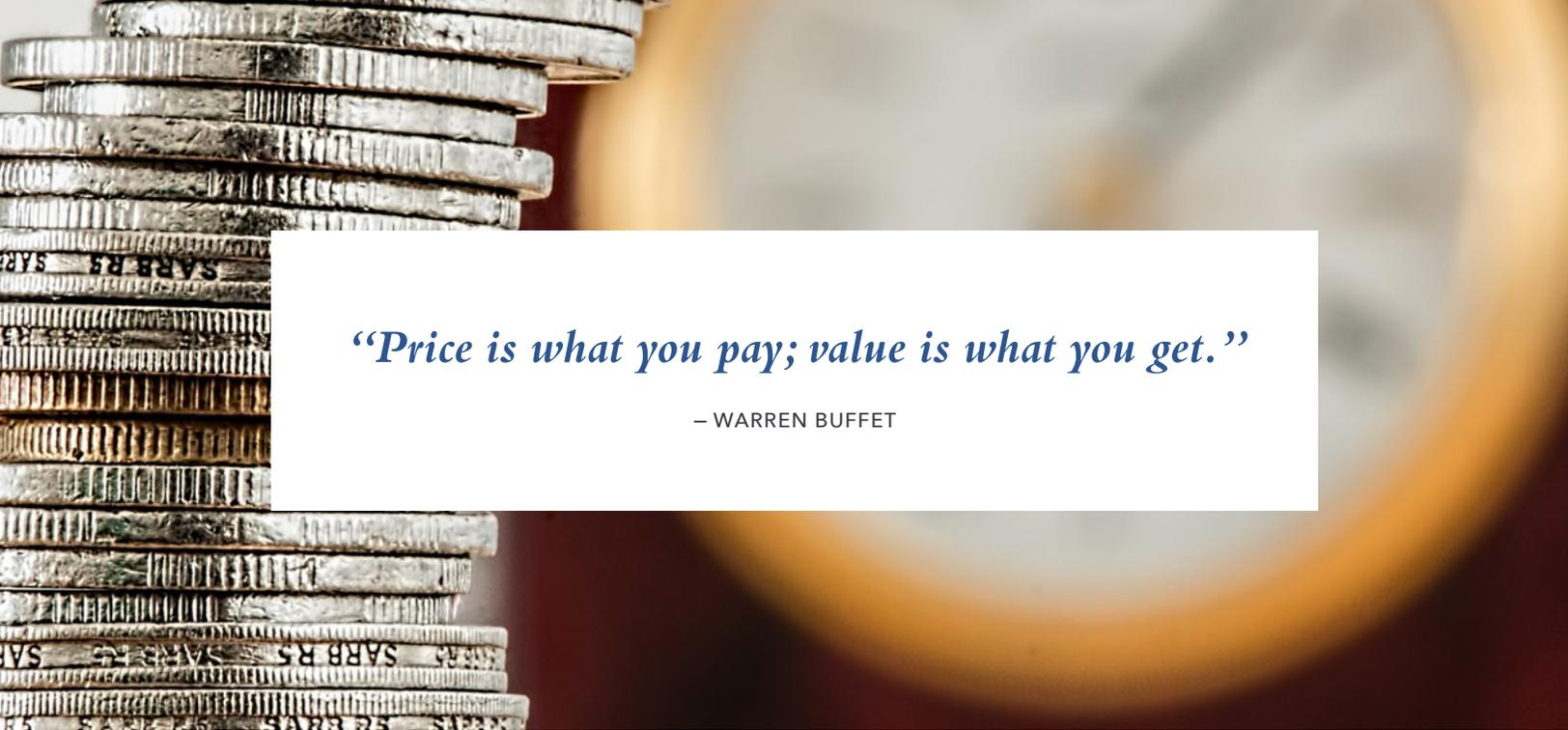


synergy **guide**

Value Investing



“Price is what you pay; value is what you get.”

– WARREN BUFFET

If you know the true value of something, you can save a lot of money when you buy it on sale.

The synergy of value

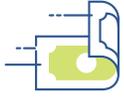
Value investing is investing in companies which have an intrinsic value worth more than their current market price. Identifying companies of this type requires extensive research to determine whether or not the investment is a worthwhile risk for you.

The danger of value investing is that though a company may have a higher intrinsic value than is recognized by the market, the unrecognized value may be too slight to invite investment, or an investment in the company may take too much time before the underlying value of the company is recognized by the market. Tying up capital in an investment must pay desirable returns in a reasonable time period because there is no reward with carrying investment inventory that is not producing.

The benefit of value investing is that a company may appreciate rapidly from its previously unrecognized value and provide high returns on investment (ROI) as more and more investors discover this diamond in the rough.

The discussion which follows will provide a good understanding of value investing, assisting you with determining your interest in being a value investor. This information is only preliminary. As always, if you're interested in exploring this topic further, we recommend you consult with a Chartered Financial Analyst® (CFA®) specializing in value investing.

The four principles



The essence of value



The protection of value

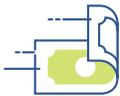


The treadmill of increasing expectations



The best owner

PRINCIPLE 1



The essence of value

The first principle of value creation is that companies generate value by investing capital raised from investors which in turn creates future cash flows at higher rates of return exceeding the cost of capital. It is the combination of growth and return on invested capital (ROIC) that creates and builds value.

Value is created for a company's owners through the investment of cash in the expectation of generating more cash in the future. The measurement of new value is calculated by determining the difference between the investment and the amount of newly created cash flows, providing the future cash flows reflect adjustment for the time value of money.

The creation of value is based on the return from invested capital, revenue growth, and the ability to continue both through time.

There is a very tight link between growth, cash flows, and return on invested capital.

Formula for deriving the investment rate: **Investment Rate = Growth/ ROIC**

Shareholders benefit from new value by the creation of high cash flows, not by the rearrangement of investors' claims on cash flows. Any activity that doesn't increase cash flow by increasing revenue or return on capital (ROC) does not generate value.

For example, if a company decides to repurchase its shares by issuing debt instruments it may change the ownership of the purchased shares but does not increase the company's value or add to the company's cash flows.



The protection of value

If it doesn't increase cash flow, it doesn't create value.

When you are unable to point to the precise source of value creation, the value you thought you saw is probably an illusion.

Research by Franco Modigliani and Merton Miller in 1958 showed that a company's value doesn't change when the debt structure and equity ownership is changed unless the company's cash flows increase.

The repurchasing of shares often does not increase a company's value because, in most cases, the business's total cash flow has not increased.

However, even if cash flow isn't increased with a buyback, some have rightly argued that repurchasing shares can reduce the likelihood that management will invest the cash at low returns. If this is true, and it is likely that management would invest the money unwisely, you have a legitimate source of value creation because the operating cash flows of the company would increase. Said another way, when the likelihood of investing cash at a low return is high, share repurchases make sense as a tactic for avoiding value destruction.

In the case of an acquisition or merger, value is created only when the two companies' combined cash flows increase because of revenue growth, expense reduction, or an improved use of capital.



The treadmill of increasing expectations

A change in the stock market's expectations of a company results in a change in the company's performance. Known as the "expectations treadmill", the more the stock market's expectations increase, the more a company must perform to meet those ever-increasing expectations.

A treadmill is a useful analogy for understanding an aspect of the mechanics of value. The market recognizes the value of a company by its share price. If the company exceeds expectations, and if the market believes that conditions will continue to accelerate the company's value, the stock price continues to rise. This in turn capitalizes the company's future value, whether or not the company's actual performance is generating the growing stock price. As the stock price increases, the treadmill accelerates and the company's appearance of performance must grow faster to meet the market's continuing anticipation of results, which, in part, is being fostered by the market's own steadily increasing capitalization. The same is true in reverse when the market has diminishing expectations for a company: the share price decreases as momentum builds in descent. It is much easier for a company to outperform in the stock market when the standards for its performance are low.

This is a good explanation for the adage that a good company and a good investment are not necessarily the same. When deciding on an investment, good companies may not be attractive in the short term because their future performance may already be calculated in their share price.

How can you tell if a company's performance justifies its current share price or if the company can exceed the expectations already calculated into its share price? You can reverse-engineer the share price in terms of the expected revenue growth's Return On Investment Capital (ROIC). Consult with a financial professional if you need assistance.

PRINCIPLE 4



The best owner

This principle asserts that the management team is an essential factor in the accretion or dissolution of a company's value. Because of their unique management styles and capabilities, different owners will generate different degrees of value from the same circumstances of a single business. The inherent value of a business can be maximized or minimized depending on who is operating it.

It's important to evaluate a company's management team to determine how effective the principle of best owner will be reflected in the company's performance and increased value. Such determinants as unique industry links, unusual skill sets, prior examples of insight and foresight, the use of strong governance models, access to special talent, proven use of capital, and recognizable influences in government or with suppliers and customers are likely to make a positive difference in a company's increasing value.

Like everything else, best owners have a lifecycle, and management turnover can be a positive influence when management becomes stale.

The stock market and value

The stock market can affect the perceived value of a company, so it's very important to understand the dynamics of how this works. Once you do, you may be able to use this to your advantage because you'll have some insight about why the market is behaving like it is.

TALE OF TWO INVESTORS

An investor named Mr. Green researches the performance of a company and arrives at a point of view about the value of the company's shares. Mr. Green decides that the shares are worth \$50, but the market values the shares at \$40. Mr. Green believes he found a good bargain, buying shares for \$10 less than the company's real value according to his analysis. He decides to buy 100 shares for \$4,000 (plus fees) and decides to hold these shares until they reach his estimated value of \$50 per share. Mr. Green believes his investment will earn \$1,000, less the cost of the fees.

Mr. Brown is another investor, and his investment approach is to find short-term movements. He's not willing to hold on to an investment any longer than it takes to make a quick profit. Mr. Brown invests in trends, and when he sees a company's share prices rising, he will buy the shares with the assumption that the price will continue to increase. Momentum investors believe that a trend is more likely to continue in its same direction, whether up or down, than it is to reverse. When the price of the shares starts to go down, Mr. Brown will sell his shares and keep his profits. He reverses his position quickly to keep his losses small relative to his gains.

THE SCENARIO

Mr. Green has done his research and believes the Temporary Temptation Company's share value is going to rise from \$40 to \$50. He makes his purchase along with other value investors, and these purchases start to move the share price higher. Mr. Brown and other short-term investors like him see the share price going up and they make purchases as well, which further increases the share price escalation. Upward momentum begins to swell, and as the price increases, investors like Mr. Green begin to slow or stop their purchases because the company's perceived value, reflected in its share price, is attained.

At some point, Mr. Green and his fellow investors start to think the shares are overvalued and they begin to sell. The trend's momentum slows and then begins to reverse, so Mr. Brown and all of his fellow investors also begin to sell the stock to lock in their profits. Now the stock price begins to fall, finally stabilizing at a lower price. This pattern most likely continues as the share price oscillates within a range set by investors like Mr. Green.

Return on Capital =

Operating Profit

Capital

Return On Capital (ROC)

The key driver for return on invested capital is a company's competitive advantage within its industry's structure of benefits and detriments. In other words ROIC is driven by the industry's structure and competitive behavior within that structure.

STRUCTURED CONDUCT PERFORMANCE

A company with a competitive advantage earns a higher ROIC because it charges a higher price for its goods and services, or it produces its products for less cost.

This model is known as the **structured conduct performance model (SCP)**, developed by Edward Mason in the 1930s. The SCP was later popularized by Michael Porter in his book "Competitive Strategy" which delineates his **Five Forces Framework**.

The SCP model professes that an industry's structure significantly influences competitive conduct which then results in the performance abilities of companies in the industry.

COMPETITOR'S CONDUCT

The final determinant of performance is the behavioral conduct of the competitors. In those industries with high capital ROIC, attractive industry structures are a main factor. Industries with low capital ROIC generally have undifferentiated products, high capital intensity, and less opportunities for innovation.

THE FIVE FORCES:

1. **Competitive Rivalry**
2. **Supplier Power**
3. **Buyer Power**
4. **Threat of Substitution**
5. **Threat of New Entry**

ROC HIGHLIGHTS

- ✓ The key factor differentiating growth companies from value companies is the ROC, return on capital.
- ✓ The optimal way to classify institutional investors is not as either value or growth investors but rather in one of these four different types: intrinsic investors, traders, mechanical investors, closet indexers.
- ✓ Research supports the notion that intrinsic investors are the main impetus for share price changes for periods of time longer than the next 12 months.
- ✓ Since the end of World War II, real corporate profits have grown about +3% to +3.5% per year, while real inflation over that same time has been about +2%.
- ✓ The median ROIC has been about +13%.

Power of pricing

PRICE PREMIUM advantages can be disaggregated into five different subcategories



Innovative products

Difficult to replicate or patent protected products, services, or technologies. Some examples are products by pharmaceutical companies, or technological innovations such as robots with artificial intelligence.



Quality

Perceived quality is the difference between one product and service or another. A wristwatch tells time, but you can have a \$2.00 model or a \$5,000 model.



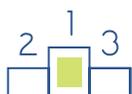
Brand

Customers often buy products based on the perceived value of a brand-name item. Owning an Apple laptop computer is often more highly regarded than owning an equally dexterous PC.



Customer lock-in

Customers may have no choice but to buy from a company when its products or services are unique or solely available in a regional area. When this happens, a company can choose to charge a price premium.



Rational price discipline

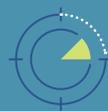
This is typically the function of one competitor acting as the leader with other competitors making price adjustments in tandem. This practice works best in an environment with four competitors or less.

COST/CAPITAL EFFICIENCY advantages can be disaggregated into four different subcategories



Innovative business methods

A company's business methods are defined as its procedures relative to the production of its goods and services, its method of delivery, and its management of resources. While it may be easy to copy some methods, innovation can be a strong factor in protecting a company's competitive edge.



Unique resources

A company using resources that are either hard to find or are manufactured in a specific way can result in a unique product or service that may give the company a significant advantage in sales, price protection or lower costs.



Economies of scale

Typically, as a company grows in size and production, it can often bring the cost per unit down, potentially increasing its profitability. An economy of scale is not always guaranteed, however, as there are many factors that bear on price, such as labor and transportation costs, etc.



Scalability / flexibility

This factor comes into play when a company can provide goods and services to additional customers while keeping its costs within a tight range. Information technology is a good example of how products and services can be delivered to more customers for a potentially negligible cost increase.

Growth

Growth is an important factor for determining a company's increase in value. Revenue growth is achieved in four different ways:

1. **Market share increases**
2. **Price increases**
3. **Growth in a new, associated market**
4. **Acquisitions**



Most value is gained by high-growth in an underlying product market. That's because the accelerated growth is coming from the loss of business by companies in other industries, flowing instead to the "invading" company which is providing a better product or service.

Value created	Type of growth	Rationale
ABOVE AVERAGE	<ul style="list-style-type: none"> ✓ New markets are created through new products. Existing customers are convinced to buy more product. ✓ New customers are attracted to the market. 	<ul style="list-style-type: none"> ✓ Established competitors don't exist; customer spending is diverse. ✓ Low risk of retaliation from competitors.
AVERAGE	<ul style="list-style-type: none"> ✓ Market share is gained in fast-growing markets. ✓ Acquisitions are made to secure and accelerate product growth. 	<ul style="list-style-type: none"> ✓ Competitors can still grow, so there is a moderate risk of retaliation. ✓ Modest acquisition premium role to upside potential.
BELOW AVERAGE	<ul style="list-style-type: none"> ✓ Market share is gained from rivals through slow but incremental innovation. ✓ Market share is gained from rivals through product promotion and pricing. ✓ Make large acquisition. 	<ul style="list-style-type: none"> ✓ Competitors can replicate and take back customers. Competitors can retaliate quickly. ✓ High premium to pay.

GROWTH HIGHLIGHTS

- ✓ It is difficult to sustain growth.
- ✓ High growth is more difficult to sustain than high capital ROIC.
- ✓ The continual search for new markets is necessary for sustained growth.
- ✓ Growth is difficult to sustain because most products have a natural lifecycle and eventually go out of fashion.
- ✓ Every product must first prove itself in the market with early adopters. Once the product receives a toehold, growth accelerates as demand increases. Growth acceleration slows when the market has maximum penetration. At this point, depending on the product sales are held to a constant rate based on the population or the economy, and sales may begin to diminish.
- ✓ Sustaining high-growth is a difficult challenge for a company of any size.
- ✓ In the final analysis, a company's size and growth are held to the size of its products' markets and the number of markets in which it competes.
- ✓ To reach and maintain high-growth, companies have to become innovative to meet the challenge of the portfolio treadmill effect. As each product matures in its lifecycle and revenues from that product begin to diminish, another product must be developed to take the place of the declining product, and more or better products need to be developed to continue growth.



Management Criteria

When establishing a portfolio of companies, these are some of the items that should be considered:

- ✓ Remember the best owner principle. There can be a considerable range of performance results because of the difference between the management styles and abilities of different owners and different management teams.
- ✓ Even managers have a lifecycle, and the best owner of a business today may not be the best owner of the business in the future.
- ✓ A major issue requiring rigorous corporate review and strategy is whether a company should build a diversified portfolio of other companies. Remember that diversification is neither good nor bad intrinsically, as it really depends on whether the parent company is able to add more value to its business holdings than another potential owner. Is the parent company the best owner, or is its potential for the growth of value limited?

Merger and acquisitions

Mergers and acquisitions can also add value to a company. Here's some key tenets to consider when deciding on a merger or acquisition, or if you are interested in investing in a company that is positioned for a merger or acquisition.

Value is created when the cash flows of the combined companies are greater than when the companies were separate.

Researchers have identified three factors that make a positive difference when a company is seeking to acquire another company:

- ✓ Companies with earnings and share price growth above the industry average during the three preceding years before the acquisition earn statistically significant positive returns upon the announcement of the acquisition.
- ✓ Companies that are purchased with a low transaction premium, which is the difference between the acquisition's estimated value and the actual price paid to purchase it, result in better returns on announcement.
- ✓ Being the sole bidder of the acquisition results in a lower price for the acquiring company.

Knowing what works is just as important as knowing what doesn't.

Four acquisition factors

that show no evidence of value creation or value destruction:

THE SIZE

The size of the acquiring company relative to the acquisition.

THE PRICE

The price/earnings ratio of the acquiring company relative to the acquisition.

ACCRETIVE OR DILUTIVE

Whether the transaction is either Earnings Per Share accretive or dilutive.

RELATED

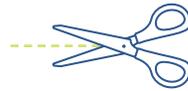
How related or different the acquiring company is to the acquisition.

Characteristics of an acquisition that create value



Performance

The acquired company's performance improves.



Excess capacity

is removed from the industry by consolidation.



Market access

The buyer's products and services receive accelerated market access.



Skills/technologies

are acquired more quickly or at a decreased cost than if they were being built.



Picking winners

By picking winners early, their businesses can be more rapidly developed.

If an acquisition does not fit one of these five characteristics, it is not likely to create value.

The only major criteria is whether or not an acquisition increases the cash flow of the combined entities over the long term.

Closing thoughts

Value investing has a lengthy history of proven success and attracts investors who are attracted to buying quality investments that are momentarily unrecognized by the market. Being a value investor means knowing how to value a company to determine if the company has intrinsic value in excess of its current market price. If that unrecognized value has sufficient potential to provide acceptable profits within an investor's preferred time period.

Many investors turn to the professional expertise of a Chartered Financial Analyst® (CFA®) who is trained both academically and experientially to make the calculations relative to market theory so promising value investments can be identified and purchased, leading to ROI and increased wealth.

If you would like to know more about value investing and how this investment strategy could benefit your portfolio, please contact us. We would be delighted to learn about your financial goals and consider how we can work together to achieve them.

Sincerely,



Joseph M. Maas

CFA, CFP®, CLU®, ChFC, MSFS, CCIM™ , CVA, ABAR, CM&AA

Chief Investment Officer

**We would be
delighted to
learn about your
financial goals
and consider
how we can
work together to
achieve them.**

It all starts with a conversation.

Give us a call and let's schedule a complimentary meeting.

206.386.5455

synergyassetmanagement.com

info@synergy-am.com

Disclosure

Synergy Asset Management LLC (“SAM”) is an SEC-registered investment adviser located in Vancouver, Washington. All content is for information purposes only and should in no way be construed or interpreted as a solicitation to sell or offer to sell advisory services to any residents where it is not appropriately registered, excluded or exempted from registration or where otherwise legally permitted.

For information pertaining to the qualifications and business practices of SAM, please contact us at info@synergy-am.com. Additional information about SAM is also available on the SEC’s website at www.adviserinfo.sec.gov. Registration with the SEC as an investment advisor does not imply a certain level of skill or training.

Information contained herein is not intended to provide any tax or legal advice or provide the basis for any financial decisions. Nor is it intended to be a projection of current or future performance or indication of future results. Moreover, this material has been derived from sources believed to be reliable but is not guaranteed as to accuracy and completeness and does not purport to be a complete analysis of the materials discussed. Investing always involves risk and possible loss of capital.

Not all services will be appropriate or necessary for all clients, and the potential value and benefit of SAM’s services will vary based upon the client’s individual investment, financial, and tax circumstances, as well as the value, marketability, and economic health of the client’s business. Personalized or specialized services, levels of experience, and professional credentials or designations, should not be construed as a guarantee of client satisfaction or any particular outcome.
