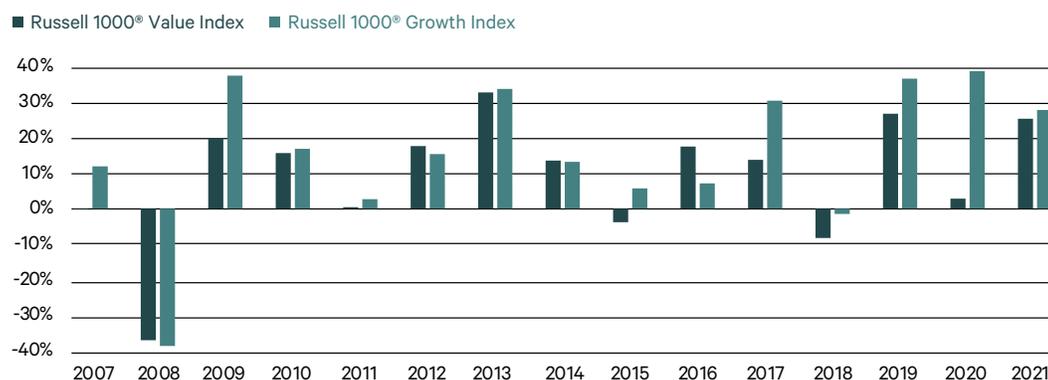


# There is No Value Without Quality

## The KAR Approach to Value Investing

When comparing returns between “Value” and “Growth” stocks, it is no secret that value has underperformed growth over the last 15 years, even including value’s recent outperformance (see chart below). Nonetheless, value investing has been the best performing style-based sub-asset class over the long term<sup>1</sup> (from 1926 to 2021). KAR firmly believes in value investing, and we expect the value stocks in which we invest to deliver attractive risk-adjusted performance based upon our definition of “value” over full market cycles. We are often asked why KAR’s value strategies do not mirror the textbook definition of value and often do not fall neatly within the value segment of a typical “style box.” In this paper, we explore the reasons for this and describe KAR’s approach to value investing, as well as explain why we believe our method bolsters value’s underlying premise while navigating its pitfalls.

### ANNUAL RETURNS GROWTH VS. VALUE



Data is obtained from FactSet Research Systems and is assumed to be reliable. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.**

### WHAT IS VALUE INVESTING? - TEXTBOOK VALUE VERSUS QUALITY VALUE

Traditional value investing focuses on “out of favor” companies that are considered underappreciated and have been overlooked while the market pursues more exciting growth (or “glamour”) stocks. The rationale for investing in an underappreciated “value” company – as the story goes – is the chance to earn outsized returns when the market realizes the stock

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*KAR’s value strategies do not fit the traditional “value” mold by design.*

<sup>1</sup> Data as of September 30, 2022. Fama French 3 Factors.

[https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html](https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html). Data is obtained from Dartmouth University and is assumed to be reliable. **Past performance is no guarantee of future results.**

is underpriced. Based on this narrative, investors will smack their collective foreheads for having overlooked this opportunity and will buy the stock, pushing up its price and delivering strong returns to those who had the foresight to establish a position early on.

We believe this is a valid investment thesis as long as there is, in fact, a viable business at the core of the “overlooked” company. In other words, if a stock is trading at a discount to its true intrinsic value, it makes sense to buy it and wait for the market to “catch up.” However, the widely followed indexes of value stocks rely on fairly simplistic metrics to determine the stocks that are included in the value category. For example, the Russell Value indexes are constructed by ranking the universe of all stocks according to their book-to-market ratios – those that exceed a certain threshold are included in a “Value” index (some indexes are further delineated by size). The MSCI USA Index defines value stocks based on three metrics: book-to-market, dividend yield and 12-month forward earnings. Morningstar’s methodology is a bit more involved, but still relies on financial ratios, namely price-to-book, price to-sales, price-to-cash flow and price-to-projected earnings, to identify value stocks.

From our perspective, there are clear issues with relying on these measures to define “value.” Some stocks have high book-to-market ratios because investors recognize that the firm’s assets are not likely to generate value in the future (a book-to-market of greater than one implies that shareholders would be best served if the company sold its assets for their book values and closed up shop). A high-dividend yield may reflect a stock whose price has justifiably declined due to a poor long-term outlook, but whose dividend has not (yet) been cut. A relatively weak 12-month earnings forecast may not just be a temporary setback; it may be a harbinger of more bad news. In other words, some value stocks are not simply being “overlooked.” Often, there is no turnaround story – these stocks have been accurately assessed by the market as having poor future prospects. In these cases, the thesis of value investing as a way of benefitting from turnarounds breaks down. The current market price reflects the company’s intrinsic value, and there is little reason to expect an improvement going forward.

## THE KAR APPROACH TO VALUE

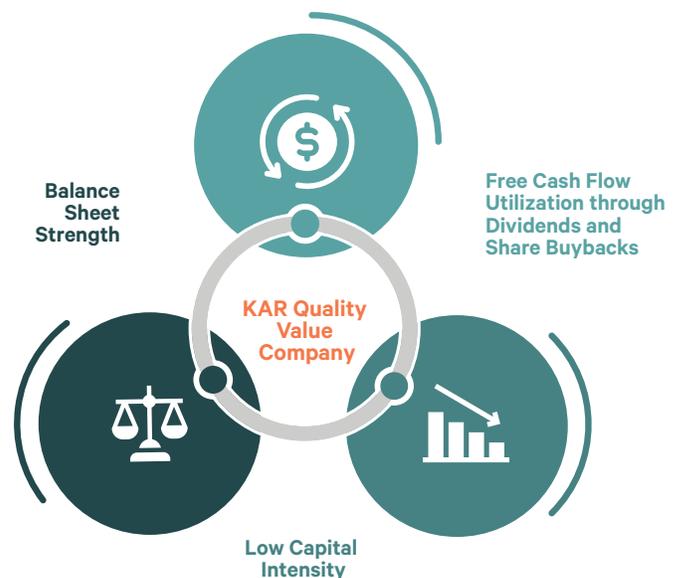
As we see it, defining a “value” stock based primarily on metrics such as price-to-book or dividend yield is often a road to nowhere because those metrics do not capture what matters most: quality. As just one example of many, a few years ago a consistently unprofitable biotech company became one of

the largest weights in the Value index, based on its price-to-book ratio. It shifted to the Growth index when the price of its stock appreciated, but is likely to return to the Value index now that the stock price has collapsed. Those who rely on metrics to define value without assessing quality will find that the company once again meets their criteria, even though the business remains unprofitable.

In our view, a number of today’s so-called “value” businesses are not poised for survival because they lack the characteristics that sustain a steady business and deliver reliable returns to shareholders. If they do manage to stay afloat, they will sputter along without attracting the additional investor attention that is key to the very premise of value investing. Investors who buy “value” based on simplistic screening criteria are likely to fall into the value trap of low-quality stocks.

At KAR, we believe *there is no value without quality*.

Furthermore, we believe the idea of discovering a turnaround opportunity before the turnaround is actually underway may be highly risky and ignores the quality aspect that defines our value investing. A quality value company can be identified by the strength of its balance sheet, and by how it deploys its capital and uses its free cash flow.



We seek low capital intensity companies that pay a healthy dividend and buy back shares to boost return on equity (ROE). We avoid those that have a history of using free cash flow to make acquisitions that do not fit with the core business, just to achieve top-line growth or to expand their product lines for the sake of expanding.

Below we compare the fundamental characteristics of our value portfolios to the universe median to illustrate how our quality value approach differs from your typical value manager.

Characteristic	KAR Small Cap Quality Value Strategy	Small Cap Value Universe Median	KAR Small-Mid Cap Value Strategy	Small-Mid Cap Value Universe Median
Return on Equity - Past 5 Years	22.4%	11.5%	25.4%	13.7%
Earnings Growth - Past 10 Years	8.4%	5.5%	9.0%	6.7%
Price-to-Book Ratio	3.0x	1.6x	3.6x	1.7x
Price-to-Sales Ratio	1.9x	1.1x	1.9x	1.2x

Data as of September 30, 2022. Data is obtained from FactSet Research Systems and BNY Mellon and is assumed to be reliable. Data for the KAR Small Cap Quality Value and KAR Small-Mid Cap Value strategies are based on representative portfolios. Actual results may vary. Other principal consultant firms may use different algorithms to calculate selected statistics. Estimates are based on certain assumptions and historical information. **Past performance is no guarantee of future results.**

## VALUE INVESTING EXAMPLE: WHICH COMPANY OFFERS VALUE?

To illustrate, consider two companies that were both classified as value stocks based on traditional metrics. One has quality at the core of its business, while the other shows no indication that a turnaround is on the horizon.

Quality Value Metrics	Company A – Household Brand	Company B – Retail Chain
Business Model	<ul style="list-style-type: none"> <li>Strong, well-known brand with steady demand for products</li> <li>Revenues and profits grow steadily</li> <li>Rarely makes acquisitions</li> </ul>	<ul style="list-style-type: none"> <li>Mall-based stores closed for months during the COVID-19 pandemic</li> <li>Struggles due to the Amazonification of the retail sector</li> <li>Uncertainty of future prominence of malls</li> </ul>
Financial Metrics	<ul style="list-style-type: none"> <li>Strong balance sheet</li> <li>Pays dividends and occasionally buys back shares to boost return on equity</li> </ul>	<ul style="list-style-type: none"> <li>Limited free cash flow and substantial amount of debt on balance sheet</li> <li>Suspended dividend issues due to COVID-19 lockdowns</li> </ul>
Capital Intensity	<ul style="list-style-type: none"> <li>Low</li> </ul>	<ul style="list-style-type: none"> <li>High</li> </ul>

KAR invested in Company A many years ago, when our analysis revealed the quality of the business and its the management team. At the time we invested, it traded at a low price to earnings (P/E) multiple, which translated into a book-to-market ratio that put it squarely into the “value” category. Over the years, the market recognized Company A as a solid company and its P/E has risen so that it no longer fits the standard criteria of a “value” stock. However, we do not believe that a success story is reason enough to sell the stock out of the portfolio. The objective of investing in an “out of favor” name at an attractive valuation is to own the stock as it moves in the right direction.

As for Company B, traditional “deep value” managers would be focused on its post-COVID turnaround potential. However, an examination of Company B’s pre-COVID story did not reveal indicators for a future turnaround, and we decided against investing in the stock. Trading at a low P/E multiple is not a guaranteed sign of quality— a cheap company may just be cheap, or worse, continue to get cheaper.

## IF THE OVERALL PREMISE IS RISKY, IS IT STILL VALUE?

Even under the best circumstances, the direction of interest rates is notoriously challenging to predict. Our value analysis avoids macro views of interest rates and the effects of federal monetary policy. Let us examine bank stocks, as an example. The current interest rate environment (as of September 2022) is moving higher off historic lows to address a 40-year high in inflation that preceded years of ultra-low interest rates that negatively impacted lending institutions' net interest margins (net interest margin is the difference between what a financial firm generates on its credit products, such as loans and mortgages, and what it pays customers of interest-bearing accounts). The current high interest rate environment is starting to positively improve net interest margin for the banking sector solely due to Federal Reserve monetary policy.

The financial services sector comprises roughly 29%<sup>2</sup> of the Russell 2000 Value Index, so value ETFs and mutual funds that hew closely to that index must hold bank stocks. Our strategies do not resemble value indexes. Banks rarely meet our quality criteria. That is because of bank stocks' strong dependence on net interest margin, which as evidenced above, is highly influenced by fiscal and monetary policy. Instead, we participate in the financial services sector by investing in companies "downstream" from actual bank stocks that are not dependent on monetary policy, such as high-quality businesses that provide services to banks and other financial firms.

## KAR VALUE INVESTING STRATEGIES SUMMARY

KAR's value strategies do not fit the traditional "value" mold by design. Our definition of "value" focuses on quality and how

companies deploy their capital and use free cash flow, rather than on book-to-market ratios and dividend yields. While we insist on a selective entry point (Quality at a Reasonable Price) we may choose to hold onto these companies rather than selling them. In many respects, our value strategies are traditional and conservative, focusing on what a company is doing now, rather than hoping that it will improve in the future. Our process strives for patience and our strategies exhibit low turnover. Instead of falling into the trap of buying stocks at a "discount" and waiting for a turnaround, KAR's approach focuses on the promise of value investing.

As the calendar year turned to 2022, several changes have taken place. The economy has continued to re-open from the COVID-19 pandemic with more workers heading back to the office. Fiscal and monetary stimulus has been tapering off and the Fed has taken a much more aggressive "hawkish" stance to fight inflationary pressures. Bearing in mind that the Federal Reserve will likely continue this path of raising interest rates, the market continues to reward lower quality businesses with greater debt and businesses that are in more cyclical industries.

We believe some of these quality headwinds will subside and the increased cost of capital will enable self-funding companies with minimal debt to persevere over the long run. From our perspective, these attributes, along with a definable moat and pricing power, should be important characteristics as we move further away from the pandemic and recognize interest rates will be higher for longer. We believe the market will seek out businesses with more earnings stability with a greater focus on fundamentals. It is this belief that gives us confidence in our approach to "value" investing over the long term.

*2 Data as of September 30, 2022. Data is obtained from FactSet Research Systems and is assumed to be reliable. The indexes are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. It is not possible to invest directly in an index. **Past performance is no guarantee of future results.***

*The Russell 1000® Value Index is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 1000® Growth Index is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Russell 2000® Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values.*

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