Value as a Philosophy

Drawing on a large body of groundbreaking work—including that of such luminaries as Graham, Buffett and Eveillard, as well as thinkers further afield—First Eagle's value-oriented investment philosophy is rooted in the belief that the greatest risk investors face is not day-to-day market volatility but rather the permanent impairment of capital, the primary cause of which is overpaying for assets.

The Global Value team takes an atypical approach in its efforts to avoid this hazard when selecting stocks. Rather than cataloging a stock based on some statistical valuation metric, the team instead seeks first to define the character of its business. By making the quantification of price conditional to our fundamental appraisal of an organization's specific tangible and intangible attributes, "value" becomes a big tent rather than an artificial constraint.

As these character-defining attributes have evolved over time, so too has our approach to analyzing and capturing their impact. Notably, intangible assets—which include factors like a business's market position and the quality of its management—have grown in prominence as the global economy has become increasingly knowledge-based, and we believe they are a key contributor to positive drift in the "intrinsic value"[1] of companies that possess them. However, intangibles are poorly represented in standard accounting practices, in our view, resulting in a divergence between "accounting reality" and "economic reality" and impacting how investors perceive value in the market.

The Global Value team's go-anywhere, benchmark-agnostic approach allows us to seek companies we believe possess a scarce, durable asset that provides it with a long-term operational advantage and is highly difficult to replicate—even in parts of the market not traditionally associated with value investing. When purchased at what we believe to be a "margin of safety"[2] to our estimate of intrinsic value and assembled in thoughtfully diversified portfolios, such assets may help our clients to avoid the permanent impairment of capital and to generate long-term positive absolute returns across market cycles.

KEY TAKEAWAYS

- The ongoing structural shift toward a knowledge-based economy heavily reliant on intangible assets—which, for the most part, are not captured in current financial accounting standards—has presented a challenge to investors seeking to identify undervalued stocks.
- Rather than dogmatically limiting our universe to only the cheapest group of stocks by some statistical measure, the Global Value team lets the character of a business dictate its potential appeal as an investment, only then attempting to assign an estimate of price.
- Our value-oriented investment philosophy is open to growth, but only growth that creates intrinsic value—a distinction we believe is far too often overlooked in markets that appear to prize potential above all. We have found that companies are more likely to deliver value-creating growth by investing in areas where they have an existing competitive advantage or there exist barriers to entry.
- Ultimately, the distinct temperament of our investment professionals—marked by patience, humility and flexibility—is key to the success of our investment process and its potential to mitigate the uncertainty that represents the true risk of investing.

1. "Intrinsic value" is based on our judgment of what a prudent and rational business buyer would pay in cash for all of a company in normal markets.
2. First Eagle defines "margin of safety" as the difference between a company's market price and our estimate of its intrinsic value.

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A Brief History of Value Investing

The concept of value investing is rooted in the pioneering research of Ben Graham, who in his seminal works *Security Analysis* (1934, written with David Dodd) and *The Intelligent Investor* (1949) sought to decouple stock investing from price forecasting. Graham's approach began with calculating an estimate of a business's intrinsic value—i.e., the present value of expected future cash flows—based on close analysis of fundamental inputs like assets and earnings. Stock of that business should be bought when it trades at a sufficient discount—or "margin of safety"—to that estimate, on the belief that market price and intrinsic value would converge over time. This "margin of safety" relieves the investor from the burden of providing an accurate estimate of the future.

The next significant step forward in value investing came from Warren Buffet and Charlie Munger, the former a student of Graham's at Columbia University. Theirs is the paradigm within which most fundamental value managers operate today, albeit with idiosyncratic variations. Unlike Graham's value model in which an investor seeks to buy fundamentally undervalued stocks and sell them when their market and intrinsic values intersect, the Buffet/Munger strategy—put to use most notably via the Berkshire Hathaway conglomerate—recognizes that certain businesses have the potential to redeploy capital in a profitable manner and thus generate strong earnings growth and attractive returns for investors over time. The companies able to do this are those protected by barriers to entry or "moats"—factors both tangible (such as well-located physical assets) and intangible (a unique expertise, for example, or strong brand recognition) that are difficult to replicate and provide a company with a durable competitive advantage.

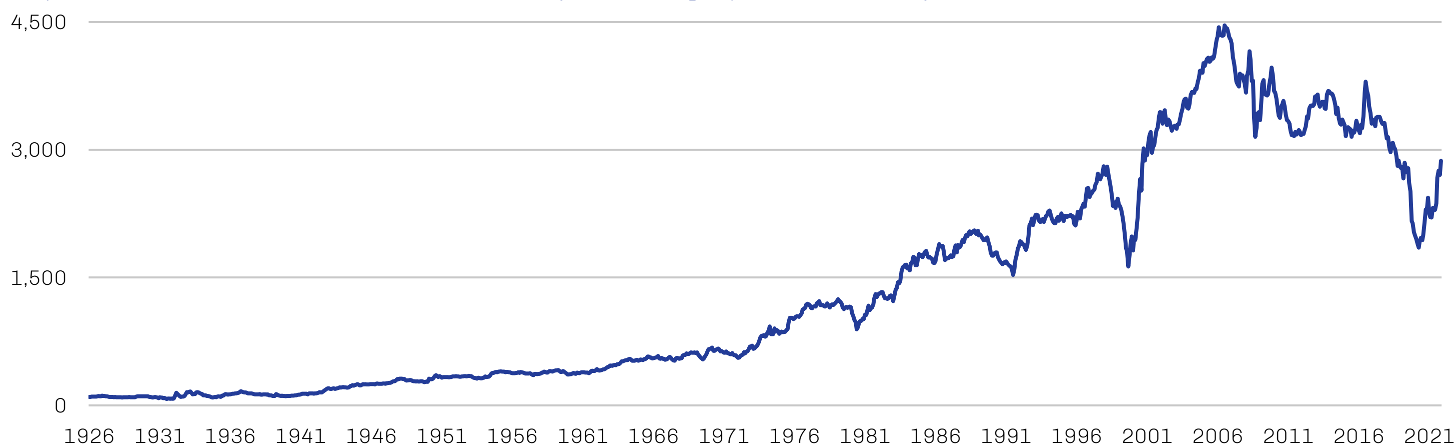
The Buffett/Munger approach to value places increased significance on a business's future potential and thus emphasizes a range of qualitative considerations that a traditional deep-value Graham approach may not. As such, security analysis is centered not around GAAP-compliant "accounting reality"—backward-looking in nature and susceptible to manipulation, among other shortcomings—but rather a more subjective "economic reality" that, if properly captured, should better reflect the aggregate character of a business, including both tangible and intangible assets that can be expected to drive its cash flows over time.

> "Economic reality," if properly captured, should better reflect the aggregate character of a business, including both tangible and intangible assets.

The most recent major development in value investing came in the 1990s with the emergence of quantitative equity strategies that leveraged improved computing power and the compilation of extensive financial databases in an effort to systematically harvest what had been termed the "value premium." Identification of the value premium is typically credited to researchers Eugene Fama and Kenneth French, who as part of the three-factor asset pricing model they introduced in the early 1990s demonstrated that stocks with high ratios of book value to market price had persistently higher returns than those with low ratios.[3] As displayed in Exhibit 1, value stocks by this statistical definition have had a long history of outperforming growth despite the struggles of the past decade-plus. That said, models that seek to identify undervalued stocks through purely statistical measures such as book value may not be as effective moving forward given the increased importance of intangible assets.

Exhibit 1. Value Has Had a Long History of Outperformance

Fama/French Value Factor Cumulative Excess Return, July 1926 through April 2022; Index, July 1926 = 100



Note: The graph depicts the Fama/French HML (high minus low) factor, which reflects the relative performance of stocks with high book-to-market (value stocks) versus those with low book-to-market (growth stocks).

Source: Kenneth R. French data library; data as of April 30, 2022. **Past performance does not guarantee future results.**

3. Eugene F. Fama and Kenneth R. French, "Common Risk Factors in the Returns on Stocks and Bonds," *Journal of Financial Economics* 33 (1993).

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The Value of Character

Rather than dogmatically limiting our universe to only the cheapest group of stocks by some statistical measure, the Global Value team lets the character of a business dictate its potential appeal as an investment. By avoiding the assumption of business homogeneity that is inherent in index-based approaches to value, either passive or benchmarked, the quantification of price becomes conditional to a comprehensive appraisal of a business's specific tangible and intangible attributes—and the value opportunity set becomes a much broader tent in the process.

Specifically, we look for companies we believe have the potential for persistent earnings power by virtue of possessing a scarce, durable asset—a tangible or intangible factor that in our view provides it with a long-term operational advantage and is highly difficult to replicate. Companies with scarce assets are not immune from the impact of business cycles, but their persistent free cash flow generation may provide a cushion against economic downturns while also creating opportunities to potentially enhance their competitive position against less-resilient businesses.

Long the basis for fundamental security analysis, *tangible* assets are fairly straightforward. We seek companies with physical resources that are well located relative to their competition—as manifest in the ability either to have consistently generated strong revenues or kept costs low—and that have a long natural duration; that is to say, assets we expect to earn a spread relative to the average asset in the same industry. Take real estate, for example. Office space in a prime business district is likely to command higher rent than comparable space in other locations while also appreciating at a higher rate. Natural resources like oil fields are an example of scarce assets at the other end of the tangible spectrum. Typically removed from population centers, oil fields' benefits are derived from their production and cost characteristics. Properties with high levels of proved and provable reserves, low operating and capital costs, and long forecasted lives will most likely be more profitable over time and generate cash flows less sensitive to fluctuations in the price of the underlying commodity.

While tangible assets are fairly intuitive, *intangible* assets require a more nuanced evaluation approach. The Global Value team has devoted significant time and resources to refining our understanding of these assets and their impact on a business's intrinsic value. We believe the analysis of a company's intangible assets can be oriented around two broad, interrelated concepts: the incumbency of its market position and the quality of its management.

An incumbent market position may be the most valuable intangible asset, as it has the potential to be self-reinforcing.[4] A dominant player in its space—whether it's kitchen equipment or computer software—can be difficult to unseat. These companies are entrenched in their industries and possess the unique expertise that implies, and their size enables them to scale fixed costs across a larger production volume and typically generate attractive free cash flows as a result. This cash can then be used to augment their already advantaged position in a concentric manner—or to put it in Buffetian terms, to expand the moat around their business. Investments in research and development can drive better product-quality mix and improved average pricing, for example, while advertising spending can enhance a company's brand and attract a broader customer base.

> We look for companies we believe have the potential for persistent earnings power by virtue of possessing a scarce, durable asset—either tangible or intangible.

As it does with tangible assets, the duration of intangible assets matters greatly to us. Just as we'd prefer a gold mine with 20 years of proved high-grade reserves over a mine with three, companies whose intangible assets have the potential to endure—evident in strong customer retention and renewal rates, stable market shares and consistent cash flows, as well as high barriers to entry that deter new competitors—are more valuable than those that may be fleeting.

While the consistency of cash flow generation over time provides a sightline into the strength and duration of a company's advantaged assets, its use of this cash can serve as a yardstick for management acumen. In our view, quality management teams act like owners, conducting the balance sheet in ways that are likely to help the business incrementally expand over time without risking its scarcity advantages. These teams maintain prudent levels of leverage, focus organic investment on areas of competitive advantage, generate favorable returns on capital deployed inorganically through mergers and acquisitions, and regularly return capital to shareholders in the form of dividends and/or share buybacks. Such a management style—which we find to be prevalent in companies whose senior management team holds significant equity or that are run by founders or families—tends to be focused less on quarter-to-quarter metrics and more on the creation of long-term shareholder value, an approach well aligned with our investment horizon.

4. On the subject of incumbency, we're indebted to Bruce Greenwald—well-known authority on value investing, recently retired academic director of the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School, and a senior advisor to the Global Value team since 2011 after serving as our director of research—whose work has illuminated our thinking.

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Mix Shift in Economic Activity Has Distorted Traditional Accounting Data

We believe the character-based approach to identifying value described above may be particularly germane given ongoing structural changes in the economy, which can be stylized broadly as a shift from "making stuff" to "doing stuff." Services accounted for 70.3% of US GDP in fourth quarter 2021, and the increasingly knowledge-based drivers of economic activity point to the greater influence intangible assets now have on corporate performance.[5]

At the same time, financial and tax accounting standards are mostly unchanged. The resulting divergence between GAAP-compliant "accounting reality" and the more comprehensive—but also somewhat subjective—"economic reality" suggests increased difficulty for those seeking to assign a value to a business. It is our view that security analysis centered on economic reality is better positioned to capture the full range of tangible and intangible assets that may be expected to drive a company's cash flows over time.

Businesses invest in the development of intangible assets for the same reason they invest in tangible assets like a new factory or updated equipment: to drive future cash flows and bolster shareholder value. While the latter are considered long-term assets on balance sheets and amortized over time, spending on intangibles—unless acquired from a third party—continues to be treated as an immediate expense.[6] Take R&D spending on the development of a unique expertise in a precision process, for example, or selling, general and administrative spending on advertising to further entrench an advantaged market position; in most instances, these expenditures have no formal worth from a balance-sheet perspective despite the obvious support they provide to a company's moat and intrinsic value. As a result, companies with significant intangible assets may have understated book values and artificially suppressed current earnings, as well as inflated valuation ratios. Further, the shifting economic paradigm and its impact on financial accounting measures also call into question the methodology for categorizing "value" and "growth" stocks and for constructing indexes representative of these styles.

> The increasingly knowledge-based drivers of economic activity point to the greater influence intangible assets now have on corporate performance.

While these trace elements of intangible assets can be difficult to screen for quantitatively, the Global Value team performs the laborious, stock-by-stock research necessary to uncover the unique advantages and risks that may be derived from assets often obscured within financial statements. Our analysts dissect financial statements and other sources of data and restate the remains to close the gap between accounting reality and economic reality and allow for apples-to-apples comparisons of different business models.

There's a subjectivity inherent in valuing intangible assets; there are no observable market prices to determine fair value for most, and the uncertainty surrounding their ultimate economic benefit is significant. Given the judgment and expertise necessary to transform intangible insights into actionable data, the institutional memory the Global Value team has developed from decades of interaction with companies on the nature of their assets and the style of management represents a significant research advantage, in our view.

Distinguishing Value from Valuation

Once we've identified what we believe to be a well-positioned, well-capitalized, well-managed company, we invest in it only when we can do so at a meaningful "margin of safety," which we define as the difference between a company's market price and our estimate of its intrinsic value. The "margin of safety" we demand is idiosyncratic to each company, a function of the scarcity and duration we see in it considering both its tangible and intangible assets.

Exhibit 2 is a stylized representation of how we view the relationship between a company's persistence and its intrinsic value. On the far left are companies in highly competitive industries with minimal tangible or intangible asset scarcity and limited means by which to acquire such advantages. Such a company is unlikely to generate favorable returns on invested capital either currently or in the future, and its intrinsic value likely is limited to the replacement cost or liquidation value of its base assets.

Migrating up the value chain we find companies that have some scarcity advantage enabling them to generate earnings in excess of the average industry participant but without the ability to reinvest in the asset. Think of an oil field depleting over time, for example, or an advantaged market position that is dissipating as consumer preferences shift. These companies generally are worth more than the liquidation value of their base assets alone, but their intrinsic value is capped by the limited duration of their advantaged earnings stream and lack of value-creation opportunity.

5. Source: US Bureau of Economic Analysis; data as of December 31, 2021.
6. Note that GAAP applies only to US companies. The International Financial Reporting Standards (IFRS) adopted by nearly all non-US markets allow for the capitalization of internally developed intangibles under certain circumstances, which has resulted in non-US companies in general amortizing a larger proportion of their R&D spending. (Source: KPMG.)

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Finally, we have those rare companies with the advantage of scarce assets currently generating strong earnings and the ability to preserve or expand that advantage by leveraging the value of their franchise. Though equity market valuations of such companies will fluctuate over time, their intrinsic value tends to drift higher in conjunction with the expansion of the global economy as the company maintains or expands its share of what has become a larger whole.

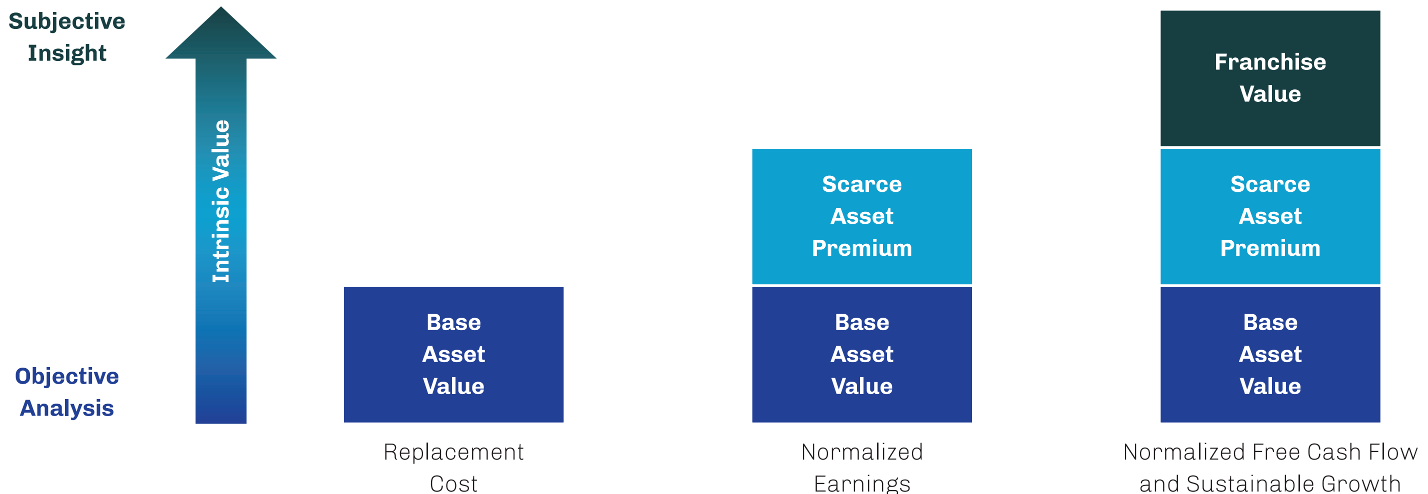
Within this category we find stocks rich in intangible assets. Unlike our benchmarked peers, First Eagle's value-oriented investment philosophy welcomes growth—but only growth that creates intrinsic value. This is an important distinction in our minds, and one that is far too often overlooked in markets that appear to prize potential above all. To create intrinsic value, the return on capital invested in a growth initiative must exceed the cost of that capital. A company can generate growth in a broad sense—in revenue, assets or operating income, for example—while at the same time destroying value due to the cost of that growth. While this idea may sound fairly basic on the surface, history demonstrates that value-creating growth opportunities are difficult for companies to identify and to execute successfully. History also demonstrates that investors at times have been willing to support outsized valuation multiples for companies deemed to have great promise, only to be disappointed when it was never fully realized.

We have found that companies are more likely to deliver value-creating growth by investing in areas where they have an existing competitive advantage or there exist barriers to entry; while the former produces high current returns on capital, the latter help insulate these returns from the deleterious impact of competition in the future.[7] This criteria is no silver bullet, however, and even a small overestimation of a growth initiative's potential contribution can have a large impact on the intrinsic value ultimately created—and thus the attractiveness of the investment opportunity.

> Even the most robust franchise faces "fade risk," or the likelihood that at some point in the indeterminate future it will begin to lose market share and eventually will cease to exist.

Further shading the conservatism inherent in our expectations is our view that all businesses are, in effect, melting ice cubes. Even the most robust franchise faces "fade risk," or the likelihood that at some point in the indeterminate future it will begin to lose market share and eventually will cease to exist. For every current business that seems immovably entrenched, there's another whose diminishing relevance reminds us of impermanence. This idea is front and center in our minds, and it reinforces our error-tolerant approach to assigning intrinsic value and to the "margin of safety" in price we demand.

Exhibit 2. Intangible Assets Contribute to Intrinsic Value



Source: First Eagle Investments; as of June 30, 2022.

Not shown in Exhibit 2 are the categories of investments that we avoid. We often use the analogy of a tennis court to describe the equities in our investment universe. We aim for the large singles court when selecting stocks, as represented by the three categories depicted in Exhibit 2. In contrast, we avoid those names that fall within the narrow doubles alleys on either side of the singles court, as we believe these investments offer unappealing risk-reward profiles. On one side are businesses that are statistically cheap but highly impaired and lacking in intangible assets, often referred to as

7. Bruce Greenwald, Judd Kahn, Erin Bellissimo, Mark A. Cooper and Tano Santos, *Value Investing: From Graham to Buffett and Beyond*, John Wiley & Sons (2021).

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"value traps." On the other are more speculative concept stocks that may pay big rewards down the line or none at all.

Consider the dynamics the accompanied stocks' rebound from the dislocations of Covid-19 in 2020 and much of 2021. We saw a great amount of enthusiasm around names perceived to have large addressable markets, be it in the tech-related giants comprising the FANG+ Index or the rash of initial public offerings of new-economy businesses and special purpose acquisition companies (SPACs). In many cases, the valuations of these stocks—which in some cases rose into the 1,000s or were infinitesimal in the case of money-losing companies—were priced to concept rather than cash, and many saw particularly sharp re-ratings in the first half of 2022.[8]

Nurturing a Franchise

Achieving franchise status is no easy task, but we have witnessed the emergence of many such companies across a range of industries. Below are a few examples.

On its surface, Japan's **Shimano**—which primarily manufactures bicycle components like breaks, gears and derailleurs—could be viewed as a mundane business. However, the production expertise, commitment to innovation and standard of quality it has demonstrated over the years has been anything but mundane. Soon after its founding in 1921 as Shimano Iron Works, the company began producing freewheels, or the ratchet mechanism that allows a bicycle wheel to spin without engaging the pedals. Perhaps tellingly, the freewheel entailed the highest level of production technology available at the time; since then, Shimano has built a dominant share in the high end of a market where technical know-how is paramount.

While bicycles and robots may seem like apples and oranges, **Fanuc**, like Shimano, has been able to leverage in its incumbent advantages in a high-precision industry to concentrically expand its footprint of dominance. Fanuc, also based in Japan, has long been a global leader in the computerized numerical controllers (CNCs) used to automate the control of machine tools, tracing its history to the advent of that technology in the mid-twentieth century. Since then, the company has continued to refine its core technological expertise while building a dense distribution and sales network and significant brand equity rooted in the reliability and performance of its products. It also has sought to leverage its incumbency advantage to expand into adjacent competencies. This has included the robotics equipment used in manufacturing processes, a still-growing market in which Fanuc already is the global number-one player.

Salesforce is a prime example of our big-tent approach to value investing. Though the US-based provider of cloud-based customer-relationship management (CRM) software would be considered a growth stock by many metrics, we believe its profile is suggestive of a business with unrecognized franchise value that may make for an attractive investment opportunity at an appropriate "margin of safety." Salesforce has a dominant market position in the CRM space, especially in a cloud segment that by our estimate has been growing at approximately 20% per year as enterprises increasingly embrace the benefits of software-as-a-service. Recent years have seen the company prudently adapt its offerings through organic product extensions and expand into adjacent verticals through acquisition while migrating toward an integrated CRM platform model. Salesforce's mature, durable market position, track record of cash flow generation and well-aligned management team gives us confidence that it possesses identifiable franchise value—in contrast with many of its peers in the technology space, whose investors often are paying for unrealized earnings and early-stage business development strategies.

Strong franchises do not insulate companies from secular trends or idiosyncratic issues, and Shimano, Fanuc and Salesforce each have faced headwinds here in 2022. That said, we believe their robust market share, solid financials and effective management may position them to potentially ride out challenging periods.

8. Source: FactSet; data as of May 31, 2022.

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Consistent Temperament in a World of Uncertainty

As likely is evident at this point, a healthy respect for risk has been integral to the evolution of our investment process over the years. The periodic emergence of unforeseen events—such as the Covid-19 outbreak in 2020 and the Russian invasion of Ukraine in 2022—serve as a good reminder that most professional investors tend to view risk through the lens of backward-looking quantifiable models that have normal outcome distributions.

> The distinct temperament of our investment professionals—characterized by patience, humility and flexibility—is key to the success of our process.

In his 1921 classic *Risk, Uncertainty and Profit,* economist Frank Knight explored the distinction between "risk" and "uncertainty." One takeaway from his book is that there is a notable difference between the quantifiable risk portfolios face—which can be modeled and, thus, managed—and the freeform ambiguity that represents the true "risk" of investing. That said, even quantifiable risk is subject to the shortcomings inherent in the deterministic financial models that seek to predict with exactitude outcomes of a system so complex as to be effectively random, a humbling insight gleaned from *A New Kind of Science*, published by computer scientist and theoretical physicist Steve Wolfram in 2002.

In short, our crystal ball is cloudy at best.

This uncertainty drives our efforts to understand the worst-case scenario for every stock we consider for investment. The end result is not a portfolio of "best ideas" but, rather, a curated collection of businesses that in our view not only appear well positioned to generate persistent cash flows over the long term but also have the capacity to suffer through short-term challenges, acquired at a price we believe offers a sufficient "margin of safety." Further, our portfolio construction process is biased toward broad diversification and incremental conservatism in the size of our holdings as an "explicit recognition of ignorance" in the words of famed investor Peter Bernstein.[9]

The distinct temperament of our investment professionals is key to the success of our process. The team must have the *patience* to wait for opportunities that meet our criteria to emerge and be willing to accept that they may never do so. *Humility*, too, is essential; accepting that we cannot see the future drives our insistence on having a "margin of safety" in our purchase prices. Finally, *flexibility* allows us to pursue our investment mandates free from the limitations of benchmarks and ensures that capital allocation decisions are driven only by the conviction of our beliefs.

9. Source: Jason Zweig, "A (Long) Chat with Peter L. Bernstein," jasonzweig.com (June 25, 2017).

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Investment in gold and gold-related investments present certain risks and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Volatility is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk.

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