

# Modern Value

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## COURSE DESCRIPTION & OBJECTIVES

### *What is Advanced about Advanced Value Investing?*

You might have heard that value, quant value to be specific, has not performed well over the last decade (though recently it is staging a remarkable return!). The returns associated with investing \$1 in four quant strategies, big value, big growth, small value, and small growth have been very different. Over the last decade, big growth, a diversified portfolio of large market capitalization low book-to-market stocks, has outperformed big value, a diversified portfolio of large market capitalization high book-to-market stocks. Does this mean value investing is dead? Absolutely not. Journalists and observers sometimes confuse quant value, roughly constructing diversified portfolios of stocks that are cheap according to some quant metric such as book-to-market, with value investing, which is about business valuation and individual stock selection. This course is about value investing: The discipline associated with constructing portfolios of individual stocks. But it is a bit more than Value investing, it is *modern* value investing.

Value Investing is the process by which, first, we estimate, within our circle of competence, the fundamental value of the business operations of the firm in the context of the competitive position the company has in the industry and markets in which it operates and, second, assess the wisdom of buying an ownership stake in the firm using the concept of margin of safety as the main risk management tool.

Notice that I wrote “process”. Value investing is indeed structured and systematic, and it needs to be because it is granular, focused on the specifics of the firm under consideration. Thus, it is easy to get lost in the details of the firm. The process helps you assess the importance of each bit of information and integrate them coherently in the analysis that combines tools from accounting, valuation, and the economics of strategic behavior.

Where do we depart in this course from the traditional value investing? Four things.

First, many observers, and not a few investors themselves, understand value in its opposition to growth, and that you can only be a value investor or a growth investor. This is nonsense. Here is Warren Buffett himself on the distinction between value and growth: *“We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value,*

*constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.”* We will tackle the issue of growth head on. First, Modern Value recognizes that growth is an issue if and only if the business operations of the firm are protected by barriers to entry. Second, it focuses on the ability of the firm to redeploy capital at higher return on invested capital (ROIC) and for the foreseeable future, that is, that the total addressable market (TAM) is large enough to absorb sustained capital deployment for the next four to five years. Thus, the focus is on ROIC, its connection with the rate of growth of earnings,  $g$ , and, most importantly, an assessment of how much we should pay for growth.

This brings us to the second theme of Modern Value: The careful treatment of intangibles. Think about ROIC. We are interested in the marginal return on invested capital: how much more NOPAT can the firm obtain per unit of additional invested capital. But most of the capital deployment in many of the modern corporations is not treated as an investment, but rather it is treated as an expense. Value investors have always been clear-eyed about the distinction between accounting, the way the financials are presented, and the economics of the business operations of the firm (think of the perennial example of Coca-Cola’s most important asset, the brand, not being reflected in the balance sheet), but this distinction is today more important than ever. We need to think about the “IC” in ROIC carefully and systematically. Intangibles are the modern economy, and it is impossible to be a good investor without having a deep understanding of how companies grow those intangible assets. That is why we devote considerable time to companies such as ADBE or PYPL (and CRM if time permits!). We also explore the limitations inherent in the valuation of the intangibles, and we assess how to bypass those limitations.

The third theme of Modern Value is that of specialization, that the good investor is a specialized investor. Specialization solves the ultimate problem in investing: adverse selection, the fact that one never knows when buying or selling whether the counterparty who is selling or buying is better informed about the prospects of the business operations of the firm being traded. One can be a specialist in many things, in a particular asset class, in an industry, or in a geographic market. Modern Value allows for the quick development of specialization by offering an integrated and coherent framework.

### **Modern Value, intangibles and technology**

The concepts of Modern Value are of course relevant across sectors, but they are particularly so in the case of technology and the new economy. A fourth aspect of Modern Value is that it does not shy away from technology and its dynamic aspects, from competitive threats to the business transformations that accompany technology revolutions. This requires a subtle understanding of the interplay between accounting, economics, and valuation.

Consider Adobe (you can see the stock price of Adobe in the last ten years in the plot below). Adobe is roughly a combination of two assets, a customer portfolio, the collection of users of its creative cloud, and the product portfolio itself, the suite of software packages, such as Photoshop and Illustrator, that make this company the leading provider of image manipulation software for marketing purposes. How do we value the customer portfolio? How do we value the product portfolio? Does Adobe have a record of translating investments in these two intangibles into earnings? How do we compute the ROIC for this company and how does that calculation depend on how speculative those R&D investments are? As you can see the case of META is instead more challenging. META consists of two business: The family of Apps (Facebook, Instagram, ...) and Reality Labs, where its virtual reality business is located. They have different economics and most importantly different records when it comes to translating R&D expenses into profitability. How can we consider these differences in our valuation process? Should both intangibles, the product portfolio in Family of Apps and in Reality

Labs, be treated the same? We will cover the case of META “on demand”, so to speak (I teach this case in the Value Investing class, but I am happy to do so as well if a substantial majority of people wants to cover it).

The course tackles this issue head on, at the expense of assumptions big and small. The key is the process though, one that will critically inform our decision whether to invest in these companies or not.

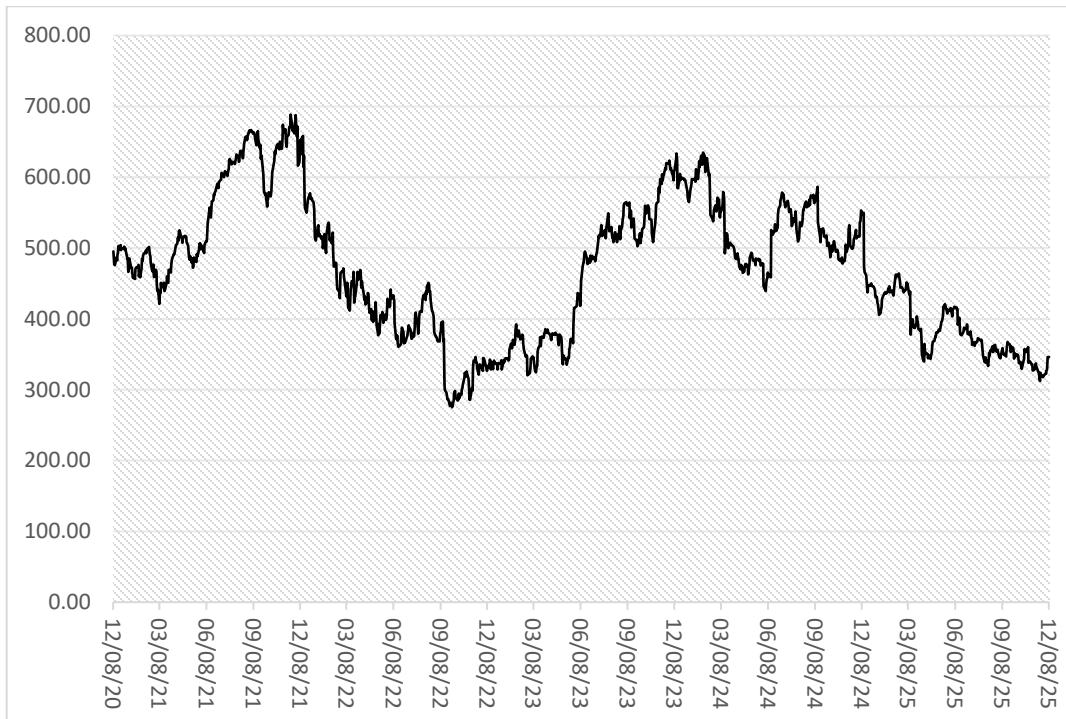


Figure 1: Stock price of Adobe, 12/08/2020 – 12/05/2025

Understanding intangibles, and technology, in particular, is challenging on two accounts. First, an assessment of the investment potential of a company in this space requires a basic understanding of what technology does and how it can be of use to customers. Second, it requires an understanding as well how technology affects the industry: Will it render some of the existing firms obsolete? Will it unbundle services that until now were provided together? Will it alter the fundamental economics of the industry? Most importantly, will it undo and create new barriers to entry? Technology then forces the investor to take the “broader” look and to place the company in the context of the industry and its dynamics; it is a critical step in the Modern Value analysis. For this reason, the course spends considerable time talking and analyzing the economics of the business operations of the firm and tracing the connections between intangible investments and profitability.

There are two aspects of the technology of the new economy that dominate today’s landscape: Subscriptions and platforms. The new economy is dominated by companies such as Netflix or Adobe that rely on subscriptions to power their cloud-based business. In addition, companies such as Google and Booking leverage the economics of platforms to generate outsized profits. We study these economics in detail.

### Why Modern Value now?

As already mentioned, the decade that goes from the global financial crisis until the onset of the Covid-19 pandemic has been one in which growth stocks have performed well above value strategies. In fact, traditional quant value measures have deviated dramatically from historical patterns: The 2010's stand as the only decade in the sample that stretches almost a century in which the returns on value, measured as stocks with low market-to-book, have come below the returns on growth, stocks with high market-to-book (we will cover this in the very first lecture) ... does this mean value is over? No. These criticisms of value are about quant value, and we are not quant investors. But we need to understand quant investing and its comings and goings, if only to argue the point!

### TEACHING STYLE

One word about the teaching style: The classes are structured as lectures. There is no "small group" work or cases to be handed in, as given the technical nature of the course it is better to have a robust in-class engagement with the material. The point is to maximize our learning with the few days that we have together, but it is important that you participate, ask questions, challenge assumptions and bring your own expertise on the topic to the class. The cases can be quite involved, both from a conceptual point of view as well as the accounting. They combine both an analysis of the pertinent strategic considerations of the company, as well as the valuation. It can get a bit demanding at times, so I will step back often in the case to assess where we are and get your take on any aspect of the analysis. Please feel free to interrupt, question and discuss. The first lecture, *From the DCF to Value Investing*, can be a tad dry, as it offers a thorough analytical description of the valuation framework. It is the framework that we will apply repeatedly throughout the three cases.

### CONTACT INFORMATION

*Professor: Tano Santos*

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I will hold office hours at the end of each day, so feel free to linger around to ask any questions you may have regarding the course. I am sure we will be tired after the long day, but let's make the most of our days together!

### RECOMMENDED COURSE MATERIAL

The main material for the Value investing is the lecture notes. Please go to the course website where all the material has been posted well ahead of the class. The material is posted under Files, and it is organized in several folders (Lectures, Cases, Annual Reports, ...). The Syllabus and Grid, which details what we are going to be doing each day, can also be found there.

There is one recommended textbook:

- *Value Investing: From Graham to Buffett and Beyond*. Bruce C. N. Greenwald and Judd Kahn, Wiley Finance, 2020, 2<sup>nd</sup> edition.

There are, of course, other important references

*The Intelligent Investor: The Definitive Book on Value Investing. A Book of Practical Counsel* (Revised Edition) [with comments by Jason Zweig and introduction by Warren Buffett].

Other interesting books that immediately come to mind are:

- *The Little Book that Still Beats the Market*. Joel Greenblatt. John Wiley & Sons, 2010.
- *Accounting for Value*, Stephen Penman, Columbia Business School Publishing, 2011.
- *Margin of Safety: Risk Averse Value Investing Strategies for the Thoughtful Investor*. Seth Klarman. Harper Business, 1991.
- *The Little Book of Behavioral Investing*. James Montier. John Wiley & Sons, 2010.
- *Berkshire Hathaway, Letters to shareholders*. Warren Buffett.
- *The essays of Warren Buffett*. Edited by Lawrence Cunningham. Carolina Academic Press.

There are two books in the intersection of accounting and valuation that are useful supporting material:

- *The Analysis and Use of Financial Statements*. Gerald White, Ashwinpaul C. Sondhi and Dov Fried. J. Wiley, 2013, 3<sup>rd</sup> edition.
- *Financial Statement Analysis and Security Valuation*. Stephen Penman, 5<sup>th</sup> edition.

### **COURSE PRE-READING**

We have few days together so in order to maximize our learning and get our “mind going” with the framework, I would recommend that you do the following readings:

- If you have access to it, read Chapters 1-3 of *Value Investing: From Graham to Buffett and Beyond*. Bruce C. N. Greenwald and Judd Kahn, Wiley Finance, 2020, 2<sup>nd</sup> edition. I will go over this material in bigger depth in the class than what is in the book, but it certainly will help if you read before the class.
- Read the following for the cases
  - Adobe
    - Annual Report – item 1
    - New York Times, “After its \$20 billion windfall evaporated, a start-up picks up the pieces,” E. Griffith, Feb 8<sup>th</sup>, 2024
  - PayPal
    - Annual Report – item 1. The annual report in the class website starts with the proxy statement, incentive compensation report and so on. The annual report starts on page 140 of the pdf file on the class website.
    - Wall Street Journal, “PayPal is back to growth in one of its oldest businesses,” Telis Demos.
    - Wall Street Journal, “Visa wanted a vast empire. First, it had to beat back its foes,” AnnaMaria Andriotis, October 19<sup>th</sup>, 2024.

- Wall Street Journal, “PayPal Is Planning an Ad Business Using Data on Its Millions of Shoppers, P. Coffee, May 28<sup>th</sup>, 2024
- Meta
  - Annual Report – items 1 and 7
  - Wall Street Journal, “Facebook Parent Posts \$42 Billion in Sales, Points to Strong Growth,” Meghan Browbosky, April 25<sup>th</sup>, 2025.
- Booking
  - Annual Report – item 1 Important: The case we will discuss in class though refers to the Booking during 2020, that is, during the pandemic.
  - Bloomberg, “ Online travel firms show pot-pandemic boom still has steam,” Natalie Lung, November 7<sup>th</sup>, 2024.
  - Barrons, “AI will revolutionize how you travel, Priceline CEO says,” Michael Kaminer, July 8<sup>th</sup>, 2024.
- I recommended the readings below to my Value Investing students back in NYC and you might enjoy them too.
  - Buffett 1977 letter
    - Paragraph on Textile operations ... how does that paragraph read from the perspective of 2024?
  - Buffet 1983 letter
    - Segment on Nebraska Furniture Mart. How does Buffett talk about that business? What does he emphasize regarding “Mrs. B’s” business acumen?
  - Buffett 1992 letter
    - Segment on Look-Through Earnings
  - Buffett 2024 letter
  - K. Langley, H. Miao, and J. Pitcher “Can Charlie Munger’s Investing Playbook Still Work? Even He wasn’t so Sure,” Wall Street Journal, January 6<sup>th</sup>, 2024.

# CONTENT

## 1. Introduction and Overview

- 1.1. What is Value Investing?
- 1.2. The Advanced Value Investing Process
- 1.3. On the (recent) performance of value
- 1.4. The course

## 2. From the DCF to Value Investing

- 2.1. The intuition
- 2.2. The algebra: A basic model
- 2.3. Adding Realism to the basic model
- 2.4. The role of strategic analysis
- 2.5. Odds and ends

### *Adobe: Asset Value and Earnings Power Value*

## 3. Growth

- 3.1. What do we mean by Franchise Value?
- 3.2. The “problem” with the DCF Model
- 3.3. Expected returns

### *Adobe: Growth*

## 4. Value investing, intangibles and the challenge of accounting

- 4.1. The “problem” with accounting: The theory
- 4.2. The “problem” with accounting: The practice
- 4.3. Adj. NOPAT, FCF, FCFE, SBC, ...
- 4.4. Asset Values
- 4.5. Details, details, ...

### *META: A complete case*

## 5. Industry Analysis: The payments industry and PayPal

- 5.1. The fundamental problem of payments
- 5.2. A brief history of payments until the credit card ... in the USA
- 5.3. Along comes the credit card
- 5.4. The payments industry: A financial perspective
- 5.5. *PayPal*

- 5.5.1. PYPL: The basics
- 5.5.2. PYPL: Asset Value
- 5.5.3. PYPL: Earnings Power Value
- 5.5.4. PYPL: ROIC and growth
- 5.5.5. PYPL & Elliott Management

## 6. Risk!

- 6.1. A framework
- 6.2. External risks
- 6.3. Investing in times of distress: [Ferrovial, 2012](#)
- 6.4. Internal risks (*depending on time availability*)

## 7. How to think about trends

- 7.1. A framework
- 7.2. Examples
- 7.3. Tourism during the pandemic crisis
- 7.4. [Booking Holdings, 2020](#)
  - 7.4.1. Booking and the logic of platform economics
  - 7.4.2. Buying Booking during the pandemic

## 8. In sum ...

# Tentative Course Schedule

### Day 1

Lunch 12pm to 1pm

Lecture 1pm to 5pm

### Day 2

Breakfast 8:30am to 9am

Lecture 9:00am to 12pm

Lunch 12pm to 1pm

Lecture 1pm to 5pm

**Day 3**

Breakfast 8:30am to 9am

Lecture 9:00am to 12pm

Lunch 12pm to 1pm

Lecture 1pm to 5pm