Tufts Investment Club - Research Group TA (Technical Analysis)
Case Study - Spring 2022
Author: Peter Kane
Research Group Leader: Gabe Moussa, Tufts '24

A Look at Deep Value Investing

Deep value investing is an investment philosophy premised on targeting stocks that are trading below their current intrinsic value, regardless of their business status. This methodology is a subset of traditional value investing but differs in the sense that it ignores seeking margins of safety and operates as a deeply contrarian strategy. Therefore, it is the "ugly businesses," or the ones with poor fundamentals, that excite deep value investors because they have the potential to offer the highest return on investment (ROI) relative to their current valuation.

In January 2021, deep value investing was popularized through the GameStop (GME) short squeeze in which the share price rose from $17.25 per share on January 1st to a peak of $500 per share during after hours trading on January 28th. Notable deep value investor Keith Gill, better known by his YouTube alias "Roaring Kitty," had been bullish on GameStop since July 2020, and uploaded a series of livestreams throughout the following months which documented his thesis behind the GME bull run.

Criteria

At the time of the publication of Gill's first GameStop livestream, the share price was a little below $4 per share. The consensus surrounding GameStop was that the transition to a digitalized gaming market would push the business into obsoletion. However, Gill believed this transition fear was overblown and referenced the emergence of a new video game console, prominent name recognition, a new management team, and a loyal customer base as motives for his bullish evaluation of GameStop. Interestingly, Gil emphasized in his livestreams that the long-term outlook for GameStop was irrelevant to his bullish thesis, and all he needed was confidence that the short-term outlook showed an undervaluation.

In addition to his GameStop livestreams, Gil used his platform to outline a loose buying criterion he used when trading stocks. The most prominent of the criteria were the following:

1). Clustered Insider Buying

Clustered insider buying is when high ranking executives within a company purchase large shares of their own company's stock. This is publicly available information and can be found on websites like OpenInsider. When executives buy shares of their company it shows that they have confidence that the price will go up and they feel optimistic about the future of their business. Gil says that, for this criterion, he typically looks for 3-5 insiders buying upwards of 200k+ shares to determine a buy signal.

2). Credit Risk

Credit risk determines how likely a company is to pay off its debts. This can be useful in analyzing how likely a company is to go bankrupt in the coming years and if it could

bounce back from large debt burdens. Gil sees the verge of bankruptcy as a ripe opportunity to find asymmetric risk and reward, remarking in a livestream: "That's when you make the most money, when the perception switches from 'this company is dead' to 'maybe this company will survive another year or two.'"

3). Systemic Vs. Non-Systemic Risk

Systemic versus non-systemic risk is the process of analyzing whether a business' performance has been due to internal factors within the company, like poor management, or external factors outside the company, like a global pandemic. If the shortcomings of business can be attributed to external factors, opportunity could arise in the regression away from these factors and a return to "normalcy."

4). No Direct Formula

In one of Gil's livestreams from July 2020, he admits that he has not found investment success when following a direct set of parameters or buy/sell signals. Instead, Gil uses a broad range of indicators, such as the ones listed above, and weighs them differently depending on how large he determines their influence on share price to be. Gil's strategy, he remarks, is based more on feel rather than math or a formulaic approach. If it were possible to create a direct by-the-book formula, quantitative experts on Wall Street would have likely discovered it by now and the market would correct itself to accommodate for the undiscovered value. Thus, successful deep value investing demands a case-specific, creative, and outside of the box approach to finding value.

5). Large Diversification

Because Gil sees opportunity in companies with poor fundamentals or those flirting with bankruptcy, he places an emphasis on diversification in order to both mitigate risk and increase the likelihood of investing in stocks that provide a high ROI. Gil recommends owning at least 15-20 different stocks and remaining confident in these investments until the share price matches the intrinsic value the investor assigned to the business and the deep value is realized.

These five principles represent only some of the criteria employed by Keith Gil and by no means encapsulates the entirety of deep value investing. Additional indicators are raising prices on products, weak competition, decreasing expenses, and any other indicator that points to undiscovered value. Ultimately, intrinsic value is inherently subjective, and it is important to have a personalized strategy which represents one's own definition of value.

The Drawbacks

It should be noted that deep value investing holds extreme risk and is not suitable for the average investor. For a trade to be successful, not only does the investor need to be of the first people to find undiscovered value in a business, but that value must also be realized through a catalyst of some sort. No matter how undervalued a business appears to be, that value will be nonexistent unless realized by a broader investment community and the share price is driven up. Therefore, because there is nothing to stop a cheap stock from getting cheaper, it is beneficial to use some sort of momentum indicator, like the MACD or the RSI, to time an investment during a downward trend reversal or during the onset of buying momentum.

Furthermore, because of the emphasis deep value investing places on financial indicators and fundamental analyses, finding undervalued stocks requires a comprehensive understanding of finance and access to stringently updated financial indicators. The essence of value investing is detective work into the intricacies of a business and finding undiscovered opportunity, an impossible task without the right tools and financial understanding.

Results

TSE: $21 to $49 = 133%
RRC: $5 to $30 = 500%
PTEN: $3 to $15 = 400%
PBF: $9 to $25 = 177%
NGD: $1 - $1 = 0%
RFP: $2 to $13 = 550%
CNR: $5 to $24 = 380%
PUMP: $5 to $13 = 160%
OVV: $9 to $49 = 444%
FTK: $1 to $1 = 0%

[Keith Gil's ROI for his portfolio from July 2020 to February 2022]

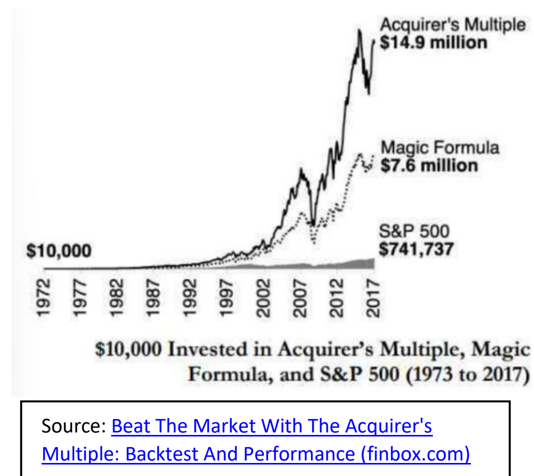
Because deep value investing is impossible to formulate and relies on personal criteria, it is also impossible to evaluate as a whole. However, there are documented examples of individual investors who have found success.

In my research, I found the first livestream of Keith Gil in which he discloses his portfolio. The livestream took place in July 2020 and showed a portfolio of 10 stocks, none of which were on the S&P 500. Using past market data, I tracked the return on investment for those stocks should Gil have theoretically held them until the present day (4/26/22). The results showed an unbelievable average ROI of roughly 274%. Although this time frame coincided with a generally bullish market and Gil likely benefited from investing during the initial Covid 19 sell off, an ROI of 274% immensely outperformed the market during this time and provides credibility to Gil's investment strategy. Furthermore, this ROI percentage doesn't even include Gil's profits from GameStop which, if he had held from his initial investment at $4 per share in July 2020 to now ($127 per share), would net a ridiculously huge ROI of 3,075%.

In addition to studying Gil, I analyzed the investment strategies of self-proclaimed deep value investors, Joel Greenblatt and Tobias Carlisle.

Joel Greenblatt is a graduate of the Wharton School, a hedge fund manager, and a professor at Columbia University. In his book, *The Little Book That Still Beats the Market*, Greenblatt outlines a strategy dubbed "The Magic Formula" for investing in companies. The formula follows a large set of criteria that can be reached through this link, but ultimately boils down to investing based on a company's total assets and free cash flow.

Tobias Carlisle, a hedge fund manager, and author of the book *The Acquirers Multiple*, employs an investment strategy based on finding companies at the bottom of their business cycle. The entirety of his strategy can be found in his book and with analysis here, but ultimately revolves around ignoring companies with debt and investing in companies with large holdings of cash and operating earnings.



$10,000 Invested in Acquirer's Multiple, Magic Formula, and S&P 500 (1973 to 2017)

Source: Beat The Market With The Acquirer's Multiple: Backtest And Performance (finbox.com)

In *The Acquirers Multiple,* Carlisle performed a back test of both his own strategy and of Joel Greenblatt's "Magic Formula" for a period between 1973 to 2017. His results showed an average annual ROI of 16.2% for "The Magic Formula" and 17.9% for his own tactic, both of which beat the S&P's return of 10.2%. However, because he performed this back test himself and may

hold biases towards his own strategy, it is important to remain skeptical of these findings and perform one's own analysis. Furthermore, past market conditions do not guarantee future results, so, even if these returns do represent accurate results, one should remain cautious.

Final Thoughts

Although the results of Keith Gil, Joel Greenblatt, and Tobias Carlisle represent successful examples of deep value investing, they are anomalies in the market and do not represent the entirety of value investing. In reality, a strategy focused on investing in businesses with bad fundamentals and on the brink of bankruptcy is highly unlikely to provide a positive return, let alone outperform the market. In fact, the entire thesis behind value investing—that there is unrealized value in the market—goes against the efficient market hypothesis that share prices reflect the entirety of information available. Historical market data shows that index funds, like the S&P 500 or the Nasdaq, provide the best and safest ROI in the long run. Although there may be short term opportunities in which value investment strategies can provide strong ROI's (Keith Gil only holds his equities for 3-24 months), they should not be viewed as successful alternatives towards investing in index funds.

About the Author

Peter is a sophomore from Marblehead, Massachusetts majoring in economics and with aspirations for law school. Within the Tufts Investment Club, he serves as a research group leader and as a student teacher for the non-profit Fit Money Fellows. In his free time, Peter enjoys fishing, reading, kayaking, and mountain biking.