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RADY SCHOOL OF MANAGEMENT
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WHAT *IS* VALUE INVESTING?

Promoting the Intelligent Conversation

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*Note: This is the first in what we envision as a series of AI-generated summaries of academic research addressing the question: "What is Value Investing?" We asked ChatGPT 5.0 to summarize the paper, "Intrinsic Value: A Solution to the Declining Performance of Value Strategies," researched and written by Derek Bergen, Dr. Francesco A. Franzoni, Daniel Obrycki and Rafael Resendes. The full version of their work may be found here. (*Complete reference at the bottom of page 3.) Brandes Center Advisory Board member Barry Gillman, CFA and Executive Director Bob Schmidt edited the original AI-generated version slightly and posed a few questions. We also added the "Disclosures" section.*

VALUE INVESTING: IT'S NOT JUST BOOK VALUE

For decades, many commentators judged value investing on a simple measure: buying stocks that looked cheap based on metrics like book-to-market ratios. It worked well, but in recent years, that simplistic strategy has disappointed investors, raising questions about whether value is dead—or merely mismeasured.

Many value investing firms use a broader approach, aiming to calculate the true worth of a company's stock: intrinsic value. A new paper, "Intrinsic Value: A Solution to the Declining Performance of Value Strategies" (Bergen, Franzoni, Obrycki, and Resendes, 2024), supports this approach. The authors say the problem isn't with value investing itself, but with the outdated yardsticks used to measure value. Their proposed fix is to swap the blunt tool of book value for a more nuanced measure of intrinsic value. In this paper, it's defined as a company's book value plus the present value of future economic profits—essentially, the returns a business is expected to generate above its cost of capital. Crucially, those profits are discounted using firm-specific rates, adjusting for size, and leverage risk. The researchers put their idea to the test across U.S. equities using out-of-sample data from 1999 to 2023, a period when value was largely out of favor. The results are striking. Long-short portfolios sorted on intrinsic-value-to-market (IV/M) ratios produced a monthly CAPM alpha of roughly 56 basis points for large stocks.

That's a meaningful return premium at a time when traditional book-to-market strategies delivered little to no excess return. Turnover was modest, so transaction costs didn't erase the gains.

Why does it work? In a world of lower interest rates, future profits matter more. Book value looks backward, often missing intangible drivers of growth, while IV/M captures forward-looking cash flows. The decline in the correlation between book value and true firm worth helps explain why book-to-market stopped working.

The message for investors: value isn't dead—it just needs better glasses, fitted with intrinsic value lenses!

APPENDIX

Brandes Center Questions:
(ChatGPT answers with Gillman's modest edits)

1. How are "future economic profits" different from future cash flows--if at all?

The authors don't forecast future cash flows directly. Instead, they forecast future economic profits (EPs).

Future Cash Flows: Forecasting cash flows requires lots of assumptions about revenues, margins, reinvestment, working capital, etc.—and is notoriously noisy.

Future Economic Profits:

The authors define Economic Profits as Operating Cash Flow minus a Capital Charge. The Capital Charge incorporates a payment function, firm-specific characteristics, and a cost of capital.

A more simplified version relies on NOPAT as follows:

Economic profit = NOPAT - (Invested Capital x Cost of Capital)

where NOPAT = Net Operating Profit After Tax.

This is a residual income measure: profits after charging the firm for the cost of all capital employed. Positive EP means the firm is creating value above its cost of capital; negative EP means it is destroying value. The conceptual difference is that cash flows measure scale.

A giant company might throw off billions in cash but still fail to earn its cost of capital. However, economic profits measure value creation. They isolate whether the firm is truly earning more than it costs to finance its assets. That's why two companies with the same cash flows could have very different economic profits if one uses capital more efficiently.

So: future cash flows = money in/out of the firm; future economic profits = profit above the cost of capital, the true "excess" value creation.

2. How are the authors calculating those profits now vs. years ago?

The authors emphasize that future economic profits are calculated systematically and consistently across the entire out-of-sample dataset (1999–2023). Every stock's intrinsic value is built from the same formula, IV is BV + sum of discounted future economic profits, and incorporates a firm-specific discount rate and economic profit horizon, the period over which economic profits go to zero and no longer contribute to a firm's value. The model and parameters to compute intrinsic value have essentially remained unchanged since 1998.

3. How are costs of capital adjusted for different firms?

The cost of capital is not a one-size-fits-all discount rate. Instead, it is firm-specific and adjusted systematically across companies. They start with a baseline cost of capital reflecting the market environment (risk-free rate + equity risk premium). This ensures that macro conditions (like low interest rates post-2008) flow into valuations.

Then they make systematic adjustments for characteristics that affect risk:

- Size effect: Smaller companies tend to be riskier and therefore get a higher cost of capital.

- Leverage: More highly levered firms face higher financial risk, so their discount rate is adjusted upward.

* Bergen, D., Franzoni, F., Obrycki, D., & Resendes, R. (2025). Intrinsic Value: A Solution to the Declining Performance of Value Strategies. *Financial Analysts Journal*, 81(2), 67–88. https://doi.org/10.1080/0015198X.2025.2467027

A PRACTICAL EXAMPLE

1. Company A: Big NOPAT, Poor Value Creation

- Invested Capital: $1,000
- Cost of Capital (10%): $100 per year
- NOPAT (Net Operating Profit After Tax): $90 per year

Analysis

- On the surface, NOPAT = $90 and looks strong.
- But economic profit = NOPAT – (Cost of Capital × Capital) = 90 – 100 = –$10 per year.
- Despite generating plenty of profit, Company A is destroying value because it earns less than its cost of capital.

NOPAT lens: Large profits.

Economic profit lens: Firm is worth *less than book value*, since it earns less than what is required by its shareholders.

2. Company B: Smaller NOPAT, Positive Value Creation

- Invested Capital: $200
- Cost of Capital (10%): $20 per year
- NOPAT: $40 per year

Analysis

- NOPAT is smaller than Company A's ($40 vs. $90).
- But economic profit = 40 – 20 = +$20 per year.
- This firm consistently earns above its cost of capital, so each dollar invested creates value.

NOPAT lens: Smaller profits

Economic profit lens: Firm is a value creator, worth *more than book value*.

Why This Example Matters in the Paper's Context

- Traditional cash-flow measures (or book-to-market multiples) might label Company A as "healthy" because of its large profit generation.
- The intrinsic value approach (future EPs discounted) shows Company B as the true winner: it compounds value creation over time.

This is the logic behind the authors' model: by focusing on economic profits, they capture whether profits are *sufficient* to cover the cost of capital, not just whether the absolute accounting profits are large.

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