Harris | Oakmark

Why the case for value investing remains strong

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For much of the past fifteen years, growth stocks delivered extraordinary returns while value managers faced persistent relative headwinds.

Many have concluded that something fundamental has changed: that the principles underpinning value investing belong to a slower, simpler economy and that the world has moved on, leaving value behind.

We believe the case for value investing remains strong, and here's why.

What we actually mean by value

Before making any case for value investing, it's worth being precise about how we define it. The term "value" is often used to describe approaches that have little in common with how we invest at Harris | Oakmark.

There's a version of value investing that amounts to sorting companies by their price-to-book ratios, buying the cheap half, and waiting for mean reversion. It's systematic, it's backward-looking, and it has become increasingly difficult to execute well. That's not what we do, and frankly, we think that version of the discipline has earned its struggles.

Our definition is simpler and, we'd argue, more durable: **value investing is trying to get a lot more than you pay for**. It starts with understanding a business as an owner would: its competitive position, cash flow dynamics, how the industry is likely to evolve. From there, we form a view of what the business is worth and buy only when the stock trades at a meaningful discount to that value. At Harris | Oakmark, that typically means we want to see a stock trading at roughly two-thirds of our intrinsic value estimate before we are genuinely interested.

Our time horizon is usually five to seven years. We ask what the business should be worth then and whether today's price gives us enough upside to compensate for the uncertainty.

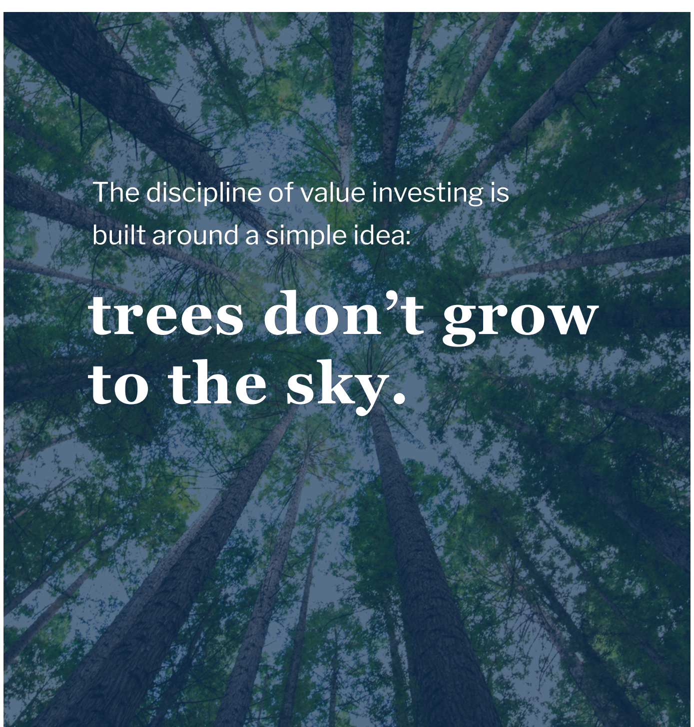
That forward view matters. **Value and growth are not opposites**. Growth is one input into value. The biggest practical difference between us and a long-horizon growth manager is that we are less willing to pay for forecasts far into the future. We are genuinely skeptical of our ability to forecast fifteen years out with any confidence. That skepticism, knowing the limits of your own foresight, keeps us grounded in what you can reasonably underwrite.

Why value returns are healthy, and growth's edge deserves respect

Something important gets lost in the narrative: value investing has not failed. Over the past decade, value strategies have returned something in the neighborhood of 10 to 11% annually. That's well ahead of inflation and, for most investors, sufficient to help them meet their financial goals. The bigger story is that growth did something remarkable, and that warrants a serious, fundamental explanation.

We did a simple exercise: we went back to 2019 and looked at what consensus expectations were for 2026 earnings of the MAG 7 and then compared those expectations to what each company is on track to report. On average, 2026 earnings are expected to be twice what was estimated for 2026 seven years ago. That was not just multiple expansion. Fundamentals improved far more than expected. Forward growth rate expectations have moved higher as well. These businesses executed at a level that, candidly, exceeded what most of us thought was possible for companies of their size.

Extraordinary business performance should produce extraordinary stock performance. In hindsight, the market was directionally right. That said, the question now is whether today's expectations are again too low, or whether investors are paying too much for extrapolation.



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What investors may be missing in today's market

Value investing has always been built around a phrase that sounds simple but requires real intellectual discipline: trees don't grow to the sky. For most of business history, high growth rates attracted competition, margins compressed, and the exceptional became ordinary. Regression to the mean was one of the most reliable forces in markets.

Today, much of the market assumes several of the largest companies in history can keep growing rapidly from already enormous bases. That may be right. Their competitive positions are exceptional. But the assumption is demanding, and investors should treat it that way. We also think investors should look carefully at what they are actually holding when they own the S&P 500. What was once a broad, diversified representation of the US economy has effectively become a concentrated technology growth fund. An investor who thinks the S&P 500 provides a balanced, moderate-risk equity portfolio is, in our view, taking on more concentrated growth exposure than intended.

A useful analogy is the Australian market, historically dominated by metals and mining—there, indexing meant accepting significant sector concentration, and few advisors would have called that a complete equity portfolio. Indexing has never been one-size-fits-all; it depends on what the index actually owns. Today's U.S. market raises the same question.

How we think about intrinsic value and what GAAP gets wrong

One of the most important tools in our process is also one of the most misunderstood: intrinsic value. Skeptics sometimes dismiss the concept as too imprecise to be useful. We'd push back on that, with one important caveat: precision is not the goal.

We think the setup for value investing today is better than the narrative suggests.

We don't believe anyone can say a business is worth exactly $80.42. That level of precision provides false comfort. What we're doing is forming a reasonable range and then requiring a substantial discount before we act on it. The imprecision is a reason to demand a larger margin of safety, not a reason to abandon the framework.

Our estimate of value has had to evolve because accounting has not kept up with the economy. GAAP prizes conservatism. If you can't touch or feel an asset, you value it at zero. That approach made reasonable sense in an industrial economy where most of a company's value resided in its physical plant and equipment. It makes far less sense today, when the most valuable assets many companies own (brand equity, global networks, customer relationships, proprietary software) appear nowhere on the balance sheet.

The Netflix[*] example is instructive. When we invested, Netflix looked absurdly expensive by any GAAP metric, trading at something close to 200 times earnings with almost no book value. But the economics looked different when analyzed on a subscriber basis, particularly when accounting for Netflix's growth opportunities. HBO subscribers were being valued in the market at roughly $800 each, while Netflix's implied subscriber value, based on projected subs, was closer to $400. Netflix was adding subscribers rapidly, and those subscribers had long, predictable lifetime values. GAAP immediately expensed customer acquisition costs that we believed created value over many years. On an economic basis, we believed Netflix was trading closer to four times earnings, a substantial discount to intrinsic value.

That's not creative accounting. That's trying to understand what a business is actually worth to an owner, rather than deferring to accounting rules designed for a different economy.

What this means going forward

We think the setup for value investing today is better than the narrative suggests.

First, the valuation gap between growth and value stocks remains historically wide. If you believe that the unusual margin expansion and growth rate acceleration of the past decade will prove permanent and universal, then current prices may be reasonable. We are skeptical of that assumption. Businesses that look extraordinary today will, in many cases, eventually face the same competitive gravity that has always brought exceptional returns back toward average. We believe the businesses we own, purchased at meaningful discounts to intrinsic value, are well-positioned if expectations normalize.

Second, as the S&P 500 has moved further into growth territory, the portfolio construction math has shifted. An investor who holds the broad index alongside dedicated growth managers now has significant unintended growth concentration. Adding active value exposure is not a bet against technology or innovation. It is a way to make sure the total portfolio reflects the investor's intended risk profile.

Third, the investors who will succeed over the next decade will be those who have done the intellectual work to understand today's business models, not those who retreat into familiar industries and wait for the old playbook to reassert itself. The value managers who struggled most were not wrong about valuation discipline. They were wrong to treat innovation and disruption as too hard to analyze. Whether it's AI's impact on software economics, the evolution of platform businesses, or the next wave of disruption we have not yet identified, staying curious and well-informed is simply the price of admission.

Value investing, properly understood, has never been about what industry a company is in, what its price-to-book ratio is, or whether it appears in a particular index. It has always been about one thing: understanding what a business is worth and having the discipline to pay meaningfully less than that.

The market environment of the last fifteen years required that discipline to evolve: to look forward rather than backward, to value intangible assets rather than ignore them, to expand the universe of businesses we are willing to consider. We have done that work, and we will keep doing it.

We believe the next fifteen years will demonstrate that this discipline, practiced with rigor and intellectual honesty, remains as relevant as ever.

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For five decades, Harris | Oakmark has delivered value-driven investment solutions with a highly active, disciplined and long-term approach. Headquartered in Chicago, IL, the firm follows a differentiated research-intensive approach to uncovering intrinsic value. Investment teams leverage intensive, bottom-up fundamental research, rigorous debate and value discipline to construct concentrated portfolios designed for consistent, competitive performance over market cycles. The firm's investment solutions span U.S., global and international equities and fixed income – and are offered in various vehicles spanning mutual funds, SMAs, LPs, CITs and actively managed ETFs.

*Harris | Oakmark initially invested in Netflix on 7/10/2017.