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**July 2024** **Number 40**

# LETTER OF VALUE

**Ruminations for investors seeking to enhance their wealth using the principles of VALUE INVESTING**

**TO OUR BUSINESS PARTNERS:**

Value trap. These are two words that strike fear into the heart of any investor, much less absolute value investors like us.

What is a value trap? It is an investment that appears to be attractively priced because it trades at low valuation metrics, yet the stock continues to decline in price for an extended period of time.

We seek to avoid value traps by conducting a qualitative assessment of each business. Among other things, we look to identify companies that do not rely on acquisitions to grow and make money in excess of the cost of the capital – equity & debt – used to achieve profits.

Sometimes a company that we own could prove to be a value trap. Even if a stock is cheap on the surface, our original thesis for the investment may become broken. Therefore, we constantly ask ourselves, if the stock was not already in the portfolios, would we buy it?

In a recent podcast, Todd Combs, who is an investment manager at Berkshire Hathaway, said Charlie Munger espoused that an investor should actively try to destroy what he or she thinks are their best ideas. This is exactly what we strive to do day in and day out.

**[1]CASE STUDY: PFIZER**

We previously exited our investment in Pfizer when the stock was being priced at less than 8 times earnings per share. It may have seemed silly to do so at the time, but in retrospect it was the right thing to do.

Our primary reason for selling Pfizer was management misallocating shareholder capital. Rather than buy back their own cheap stock, they were focused on making large and expensive acquisitions.

After no acquisition activity in 2020 and 2021, Pfizer spent a net $23 billion in 2022 and $43 billion in 2023 on acquisitions, and the prices paid were at nosebleed levels.

We simply do not believe that Pfizer will earn a good return on this investment and is thus destroying shareholder value in the process. More oftentimes than not, this is a recipe for disaster.

Another concern was that Pfizer is staring at a “patent cliff” in the not-too-distant future. This is when patents expire and pharmaceutical companies subsequently lose exclusivity on drugs.

This opens drugs up to competition from generics. When this happens, pharmaceutical companies typically experience a sharp fall-off in sales for drugs.

Although Pfizer had been spending a significant amount of money on internal research and development, their productivity on this investment has been poor. The drug pipeline is less robust than what management would lead one to believe.

As such, Pfizer’s inability to replace the pending loss of sales, once patents on top-selling drugs expire, via internal investment, is perhaps why the company has resorted to buying firms at high prices.

Lastly, a concern was that Pfizer’s ability to control their own destiny is diminishing due to increasing government involvement in the pharmaceutical industry.

Governments are aiming to reduce prices for medications, including blockbusters that account for a large percentage of sales, for the well-being of the public.

In fairness, Pfizer is not the only pharmaceutical company that is contending with these headwinds.

[1] This is not a recommendation to buy or sell the stock.

Maybe there will come a time when we revisit pharma companies if the industry's prospects improve, but for the time being, we have moved to, and will remain on, the sidelines.

By taking a "clean sheet of paper" to Pfizer and selling the stock, we were able to subsequently avoid a nearly 30% decline in the share price.

We will not get every investment right. In fact, we have fallen prey to value traps before. This is a humbling business.

However, by focusing on valuation, conducting qualitative assessments of businesses, and being intellectually honest with ourselves, we seek to not only get more right than wrong, but also minimize the impact of a bad investment.

We thank you, our clients, centers-of-influence, and business associates, for your ongoing trust and confidence.

*Contrarian investing is inherently painful. It goes against human nature, and it's deeply uncomfortable. That's why it works for the patient investor, emphasis on patient.*

-Rob Arnott, Research Affiliates

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