

Value as a Vector: Profiting from the Direction of Value

April 2026

Executive Summary

- **The Vector Principle:** Value is not a static point; it is a vector defined by magnitude and direction. We prioritize the *direction* of travel over a single-point estimate of value.
- **Eliminating Value Traps:** Focusing on companies that are building value gives us greater confidence that price will converge up towards an increasing value over our holding period, rather than price falling to a lower value.
- **Tiering for Value Creation and Durability:** We confirm quantitative value through a qualitative “Tiering Analysis” that evaluates a company’s ability to build value over time.
- **Behavioral Edge:** Mispricings exist because market participants make cognitive and behavioral errors. Our process is designed to exploit these errors while mitigating our own.

In the pursuit of “Value,” many investment managers fall into a common cognitive trap: the illusion of precision. They spend thousands of hours constructing complex discounted cash flow models, arriving at a specific dollar amount—say, \$142.87—that represents their opinion of a company’s intrinsic value. When the stock trades at \$110, they see a “bargain.” However, this obsession with decimal points often leads to an overconfidence bias, where a manager becomes “precisely wrong.” They miss the forest for the trees, failing to see that while their point estimate is precise, it is irrelevant because the company’s fundamentals are unlikely to drive a price anywhere near that estimate.

At Cornerstone, we recognize that the market is a complex adaptive system driven by human emotion and cognitive errors. While the market may disagree on a specific point estimate of value at any given moment, it eventually recognizes and rewards a company that is consistently building value over time. Therefore, we do not view value as a point. We view value as a **vector**.

The Vector: Magnitude Plus Direction

A vector, by definition, has both a value (magnitude) and a direction. For an investor, magnitude is the current mispricing, while direction is the business's fundamental trajectory. Most value traps occur when a manager identifies a high magnitude (a "cheap" stock) but ignores a flat or negative direction (eroding value).

To address this potential problem, our proprietary Fair Value Model, which has been utilized for over 30 years, assesses our investable universe by considering the potential direction of future value.

1. Normalized Fair Value (The "Normal Year")

This represents a company's intrinsic value based on a synthetically constructed "normal year" of earnings power and growth. We derive this from a 3-to-7-year historical average of adjusted results.

- **Future Normalized Value (its direction):** This projects what that Normalized Value will be *next year*, assuming the company does what is expected of it, based on consensus expectations.

2. Razor Value (The "Current Environment")

This is a "ruthless" valuation based on how the company is operating in the current (trailing twelve months) economic environment.

- **Future Razor (its direction):** This projects the Razor value for the *next fiscal year* based on consensus expectations.

Valuation Metric	Temporal Focus	Directional Component
Normalized Fair Value	"Normal" Cycle estimated over 3-7 years	Where will the Normalized Value build to Next Year?
Razor Value	Current Environment as reflected by the trailing twelve months	Where will the Razor Value be after the next Fiscal Year?

The Law of Financial Gravity

By focusing idea generation on the direction of value across these metrics, we eliminate many potential value traps during our screening process. If a company appears "cheap" but its **Normalized** or **Razor** values are declining, we see a red flag. Eroding values often point to eroding fundamentals.

Conversely, when the direction of value is positive, we gain confidence that the "law of gravity" will take effect. Over the short term, stock prices are volatile and influenced by the "herd mentality" or "overreaction" of market participants. Over the long term, however, we believe the stock price will inevitably be pulled up toward rising intrinsic value. That also enables us with the ability to identify and own businesses that are both high-quality and remain attractively valued over a longer time frame, taking advantage of the asymmetry and right-skewedness of public market investing.

Deep Fundamental Review: The Tiering Analysis

A quantitative vector is only the starting point. To understand if a company remains a "strong builder of value," our team conducts an intensive fundamental review. A key element of our fundamental review is our proprietary **Tiering Analysis**, through which we assess the likely path and durability of a company's earnings power through five pillars:

1. **Value Creation:** Proven material growth in profit per share and a message that resonates with the market.
2. **Competitive Edge:** Moats driven by attributes including scale, pricing power, strong brand equity, or network economies.
3. **Durability:** Predictable revenue streams in concentrated industries with minimal disruption risk.
4. **Quality of Financials:** Strong, self-funding balance sheets with high accounting quality.
5. **Quality of Management:** A track record of disciplined capital allocation and a clear strategic vision.

Within our **Concentrated 30** strategy, we prioritize Tier 1 and Tier 2 businesses—those where the qualitative evidence confirms that the "upward vector" is driven by sustainable, embedded characteristics rather than temporary cyclical tailwinds.

The Mosaic Approach to Valuation

Finally, we employ a **Mosaic Approach** to assessing valuation. We synthesize quantitative modeling, qualitative tiering, and a broad array of external data to determine if the market's current pessimism is misplaced. Whether we are analyzing the impact of AI on payment rails or the effect of regulatory interest rate caps, we look for "behavioral errors"—times when the market's fear has driven a price far below the vector's path.

Conclusion: Process Over Emotion

At Cornerstone, our advantage is not in having "better" information; we do not seek to out-research the market; we seek to out-process the market. We accept that we cannot be "precise" about the future, but by focusing on the **Vector of Value**, we ensure we are directionally accurate. We avoid the "precise wrongness" of static models and instead align ourselves with companies that are actively building value. When the fundamentals are repeatable, and the direction of value is up, we trust the law of financial gravity to do the rest.

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