Value Investing Vs. Modern Portfolio Theory

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What value investors do is not well known or understood. This is because universities have accepted the notion that markets are efficient and, as a result, teach modern portfolio theory, which cannot be more different than value investing.

Value investing is a style of investing developed in the early 30’s by Ben Graham at Columbia University [1]. It involves a three step process – even though most people believe the process is limited to only the first step. First, identify possibly undervalued stocks by choosing stocks with low price-to-earnings (P/E), price-to-book (P/B) or other valuation related metrics, second, value in depth the stocks that pass the screening process to estimate their intrinsic value and third, make an investment decision to buy only if the stock price is below the intrinsic value by a predetermined margin of safety – value investors are very careful of valuation risk, which is paying too much. Value investors are contrarian (bottom up) stock pickers with long term perspective.

Does value investing work? In answering this question, academic research focused primarily on the first step of screening as academics do not know what stocks value investors actually buy, but they do know that they tend to buy from the low P/E or P/B group of stocks. Such research showed that thus defined value investing works. Value stocks (low P/E or P/B) outperform growth stocks (high P/E, P/B) in Canada, in the US and Global markets (see, for example, Basu [2], Chan, Hamao and Lakonishok (1991), Fama and French [3-5], Lakonishok, Shleifer and Vishny [6], Chan and Lakonishok [7] and Athanassakos [8,9]). They outperform when the markets go down and when they go up, and in good and bad times and when news is good and when it is bad. And they do all this without having higher risk, as measured by beta or standard deviation or adverse states of the world.

Other academic research, better focused on what value investors do, also showed that value investing works. Kacperczyk, Sialm and Zheng [10] and Kacperczyk and Seru [11] examined whether skilled managers exist. The researchers studied about 1,700 actively managed U.S. funds from 1984-99 and 1993-2002. They found that the more concentrated a fund was - in other words, the less diversified - the better it did. The outperformance resulted from selecting the right sectors or stocks, not from market timing. Additionally, the studies found that the lower the reliance on public information and the greater the reliance on portfolio manager’s own skill, the greater the outperformance. Value investing is all about concentrating a portfolio to a few selected truly undervalued stocks. And as Keynes one said “once you attain competence, diversification is undesirable”. Buffett echoes this view.

Athanassakos [12], in the first direct study of value investors, examined whether value investors add value over and above a simple rule that dictates they invest only in stocks with low P/E and low P/B ratios. The author found that value investors do add value, in the sense that their three-step process of selecting truly undervalued stocks produced significantly positive excess returns over and above the naive approach of simply selecting stocks with low P/E and low P/B ratios.

As noted investor Sir John Templeton said, “It is impossible to produce a superior performance unless you do something different from the majority” Montier [13]. Being contrarian and doing something different from the majority is precisely what value investors do.

If the evidence in favour of value investing is so overwhelming, why isn’t everyone a value investor? Why does a value premium (i.e., that value, on average, beats growth investing) still exist? Shouldn’t it be eliminated? Not necessarily, because the driving forces behind the value premium are human psychology and institutional biases.

Human and institutional behaviour bias stock prices in such a way that give rise to the value premium. Individuals are subject to irrational behaviour. They extrapolate, they are overly optimistic, they overreact and most importantly they herd [14]. They herd to protect their jobs. If the group loses and a portfolio manager is in the losing group, his job is protected as he lost as everyone else - but if he is wrong and others win while he loses, then his job and reputation are at stake. As John Keynes had indicated “It is better to fail conventionally than succeed unconventionally” [15].

At the same time, individuals working for institutions have their own agendas that may conflict with those of their clients or investors [16]. They act on these agendas to benefit themselves, rather than those who hired them. They rebalance their portfolios throughout the year to earn their Christmas bonus, they window dress to spruce up their portfolio to look better than they are to their clients and herd to protect their jobs [17].

Weaknesses of human nature and institutional biases are not going to go away - just as portfolio managers do poorly not due to lack of stock picking abilities, but rather due to institutional factors that encourage them to over-diversify to protect their jobs and assets under management, investors will also continue to believe the promises that growth (glamorous) stocks make, overbidding them, and giving rise to the value premium.

References


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