

Why value investors can still outperform the market: An excerpt from a new book by Dr. George Athanassakos

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Given how successful value investing has been in the long run over different time periods, and given that the evidence has been out there for years, why is everyone not a value investor? Why don't we all do the right thing and invest as value investors?

Let's look at this question from an individual investor's point of view. Why don't we all do the right thing? Because humans are not rational. Our worst enemy in investing is our human nature. We get greedy, we panic, we herd, we are undisciplined and impatient, particularly when it comes to investing.

A few years ago, Blackstone produced a report in which they showed that even though the average equity mutual fund in the U.S. averaged 8.2% per year over the period 1992 to 2011, investors who invested in these funds averaged only 2.3%. The reason was that investors tried to time the market. Individual investors are the worst market timers. They were panic stricken at the bottom of the market and exuberant at the top. And so, they bought high and sold low. For example, in September-October 2008 and more recently in March 2020 everybody was panic stricken, and they were selling. Instead, that was the best time to buy.

Let's look now at this question from an institutional investor's and portfolio manager's point of view. Professional portfolio managers are supposed to be well trained, experts in control of their emotions and well paid. Why don't they do the right thing? Because professionals are prone to conflict-of-interest problems.

It is sad to say, but they don't do the right thing because they don't care about doing the right thing. What they care more about is not losing their jobs, or not lose assets under management. As we saw earlier, low Price-to Earnings or Price-to-Book stocks (the so-called value stocks) do not beat high PE or PB stocks (the so-called growth stocks) every year. They do on average. Sometimes it takes four years or more as we have seen in more recent years for the so-called value stocks to beat growth stocks, and so if they go out on a limb and invest in value stocks and underperform even for a few quarters, what do you think will happen to them? They are going to get fired. The safest thing for them to do is to gravitate towards an index. They will never tremendously underperform. They will always be in the ballpark. Because of this, about 40% of mutual funds are closet indexers.

When you read studies and books indicating that the average portfolio manager underperforms, it is not difficult to understand why. If 50% of the sample used consists of closet indexers, it is hard to show outperformance. If, on the other

hand, you read more recent studies, which are more carefully done, they do show that narrowly focused funds that invest in 20-30 stocks tend to outperform. European boutique asset managers tend to outperform those managed by Europe's largest fund management groups; the less diversified a fund is the better it does, with outperformance resulting from selecting the right stocks, not market timing; and the U.S. funds that deviate significantly from their benchmark portfolio outperform their benchmark both before and after expenses. The further away a fund is from the index, the better it does. In other words, portfolio managers underperform not because they lack stock picking abilities, but rather because institutional factors force them to overdiversify. The incentive system forces them to overdiversify and this leads to their underperformance.

There are two forces that drive the premium ascribed to value investing. First, it's human nature. And second, it is the conflicts of interest portfolio managers face when they manage other peoples' money. These two forces interact to bias stock prices and give opportunities to value investors, who overcome the weaknesses of human nature and the conflicts of interest of portfolio managers by "eating their own cooking" to outperform. Both underlying forces are not going away any time soon. That is, humans will continue to be humans and institutional investors will continue to have conflicts - which are very difficult to eliminate. As a result, if human nature will not change, and the conflicts of interest of portfolio managers will not change, it is reasonable to conclude that the value premium will continue to exist in the future.

It is important to understand the weaknesses of human nature, especially as it applies to investing, in order to be able to see these weaknesses in your own behaviour and try to control them or devise strategies to deal with them.

(a) Humans are not Rational

The first academics who talked about human nature were psychologist professors. One of them, Daniel Kahneman, won a Nobel Prize. He used to ask his subjects to play the following game. He would give his subjects \$500 or the opportunity to toss a coin - if they tossed heads, he would give them \$1000 but if they tossed tails, he would give them nothing. Most people would choose the guaranteed \$500 option over the coin toss option. Then he would give them the option to lose \$500 or the opportunity to toss a coin - if they tossed heads, they would lose \$1000 but if they tossed tails, they would lose nothing. Most people would choose to toss the coin. This way he demonstrated that humans are not symmetric. When they win, they become risk averse and when they lose, they become risk takers. In the well-known "Deal or Not Deal" game on TV, game participants demonstrate exactly this behaviour. Kahneman, through his experiments, demonstrated that humans are not rational. They are not the dispassionate calculating machines that market efficiency assumes they are. And he provided further evidence against market efficiency and the way it is taught at universities around the world.

Kahneman's experiments have implications for investing in the stock market. Investors who hold positions in the stock market tend to sell their winners too soon and hold on to their losers for too long. That is, when they are making profits (i.e., win), even if the stock has further upside, they sell because they become risk averse and they do not want to play the game anymore. On the other hand, if they are experiencing losses, even if the stock has only downside, they stick to holding the stock. Humans don't want to sell at a loss, because if they do, they admit that they made a mistake. This is what is referred to as "the pain of regret."

(b) Humans are Momentum Traders & Have Short Memory: Representativeness Bias

Humans have a short memory span; they remember the recent past. They tend to extrapolate the past naively. They believe that if a stock has been a winner, it will continue to be a winner going forward; the opposite for the losing stocks. And so, they keep buying the winners and selling the losers. This is what creates the vicissitudes of stock prices. This may seem inconsistent with what I just said under point (a) - but it is not. This is because point (a) above refers to stocks you already own, while this section refers to stocks you do not own.

(c) Humans are Overconfident About their Abilities and Overoptimistic: Investors Traded too Aggressively

Overconfidence is part of our human DNA. It has been built over millions of years of our evolution. Think of our ancestors, the cavemen, who came out of their cave with a little stick to kill a mammoth. They must have been very overconfident and overoptimistic. But if they didn't do this, they wouldn't survive. Overconfidence allowed them to survive and to mate. We are overconfident in every aspect of our lives. A survey at Harvard found that 80% of graduates said they were better looking than average. How is this possible? But when overconfidence comes into our investing, this is bad for our wealth. We tend to become day traders and market timers and it does not work.

In fact, there is some academic research which shows that because men are more confident than women, women tend to do better in investing than men.

(d) Human Tend to Overreact

We overreact on the downside; we also overreact on the upside. That's why the bull markets tend to be stronger than they should be and the bear markets weaker than they should be. And the less reliable the source of the information is, the more we overreact. There were many such stories of overreaction to unreliable information in the late 1990s and early 2000s during the dot-com bubble.

(e) Humans Exhibit Biased Self Attribution

Humans see order when there is none. They like shortcuts and devise rules of thumb, which sometimes work by accident, but mostly do not. Humans also interpret accidental success to be the result of skill. They are lucky yet think they are skillful, and so next time, they bet the farm and lose. One can meet many such people during Christmas' cocktail parties. Finally, we tend to believe more information that agrees with our views. We tend to think inside the box.

(f) Humans Herd

Humans change their behaviour in parallel. We are social beings that like to be in groups. As individuals, if we see the crowd go in one direction, we think that the crowd knows something, and we go the same way. As professionals, we know that no one lost his or her job because of average performance. If we are in a group and the group loses, it is not a big deal. But if we go out on a limb and go on a different direction than the group and we lose, when the group wins, we may lose our jobs. As John Maynard Keynes used to say, "*It is better to fail conventionally than succeed unconventionally.*" And the more the risk, the more we herd. That is why herding is more prevalent in smaller companies, in growth stocks and emerging markets.

Analysts also herd. The low ability analysts hide in the group. The good analysts already made a good name for themselves so why go out on a limb?

Think about this now. Analysts say buy General Electric (GE). Portfolio managers rush to buy GE because analysts recommend it. They are all overconfident, they extrapolate, and they herd. What is going to happen to GE's stock price? It is going to shoot up. The opposite is going to happen if GE is a sell. It is, thus, human nature that creates the ups and downs in stock prices around intrinsic value.

We have to see the above weaknesses in our own behavior and become mindful of them. We must try to deal with these weaknesses or, much easier, develop strategies to deal with them. I have five rules that I apply to train myself, as it is very difficult to control our emotions unless we are lucky enough to have been born with such skills. First, always look before you jump. That is, never make impulsive decisions. No matter who says buy, step back and evaluate the situation. Second, always think of the opposite. If you invest with the crowd, you will never outperform. You will outperform your peers only if you do something different. In fact, American billionaire investor Seth Klarman says that on average, in the long run, the crowd is always wrong. Third, develop an analytical process to make decisions. Like the process you will learn in this book; when to buy, when to sell and so on. This process helps you overcome your emotions. Fourth, always have a check list of things you like, or you do not like, in a stock and use this before you make decisions. Check lists are good to have when the

risk is high. That's why airline pilots have check lists. Fifth, always talk to a knowledgeable friend. Even Warren Buffett talks to Charlie Munger and bounces ideas. Value investors work in groups. They meet every quarter, discuss stocks and bounce ideas. No one knows everything.

To conclude, it is human nature that biases stock prices and causes the divergence of value from price.

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