Stop your active portfolio manager bashing. Skill does still matter

GEORGE ATHANASSAKOS >
SPECIAL TO THE GLOBE AND MAIL
PUBLISHED AUGUST 8, 2023
UPDATED AUGUST 9, 2023
FOR SUBSCRIBERS

Are markets efficient? Can active investors (stock pickers) consistently find stocks where value and price differ?

Proponents of market efficiency (i.e., academics) believe that any outperformance by active managers comes purely from luck. They recommend that the investor hold the market portfolio, instead of actively seeking undervalued stocks.

But evidence shows that seeking undervalued stocks works, both using aggregated and disaggregated data.

First evidence using aggregated data. Funds that invest in concentrated portfolios and/or deviate significantly from benchmarks tend to outperform, according to recent academic studies. For example, Marcin Kacperczyk, Clemens Sialm and Lu Zheng find that the more concentrated a fund was the better it did. The outperformance resulted from selecting the right sectors or stocks, not from market timing.

Martijn Cremers and Antti Petajisto show that those U.S. funds that deviated significantly from the benchmark portfolio outperformed their benchmarks both before and after expenses. And a study at UCLA co-written by Söhnke Bartram and Mark Grinblatt shows that “one can earn risk-adjusted returns of up to 9 per cent a year with rudimentary analysis of the most commonly reported accounting information. Such abnormal profits are a result of fundamental analysis and taking advantage of market inefficiencies.”

How about using disaggregated data? How have high-profile value investors faired over long periods of time. Academics have argued in recent papers that Warren Buffett has been lucky. But how about all the others who have followed the value-investing process? They cannot all be lucky.

INVESTOR NAME	AVERAGE PERFORMANCE P.A.	INVESTMENT HORIZON
Warren Buffett	20%	60 years
Bill Ruane	4% over benchmark	37 years
John Neff	3% over benchmark	31 years
Charlie Munger	16%	60 years
Nomad	12% over benchmark	14 years
Li Lu	16%	21 years
Howard Marks	19%	22 years
Tom Russo	2.8% over benchmark	25 years
Chuck Akre	6% over benchmark	22 years
Michael Price	5% over benchmark	20 years
Walter Scholss	16%	49 years
Paul Singer	14%	36 years
Peter Cundill	2.4% over benchmark	35 years
Francisco Parames	8% over benchmark	20 years
Marty Whitman	3% over benchmark	22 years
Seth Klarman	4% over benchmark	37 years
John Templeton	4% over benchmark	35 years
Tweedy Browne	9% over benchmark	16 years
Jean Marie Eveilard	16%	25 years
Ben Graham	2.5% over benchmark	20 years
Prem Watsa	19%	30 years
Julian Robertson	7.5% over benchmark	20 years
L. Cooperman	3% over benchmark	27 years
T Rowe Price	4% over benchmark	37 years
Paul Tudor Jones	24%	26 years
Glenn Greenberg	18%	25 years
Rob Rodriguez	6% over benchmark	25 years
John Maynard Keynes	6% over benchmark	24 years

SOURCE: SCOTT REARDON, DAKOTA VALUE FUNDS

And remember four things:

First, no one claimed that the value-investing decision process works all the time. It works, on average, in the long run.

Second, while recent U.S. studies showed that value investing was dead, this finding was the result of confusing value investing vs. the value-investing process.

The value-investing process involves three steps. Initially, value investors screen stocks and form portfolios based on a number of metrics such as P/E, P/B, market cap, etc. and focus on stocks in the lowest ranked portfolio. This allows them to identify stocks that have desirable characteristics (i.e., low price vs. fundamentals) and, at the same time, reduce the number of stocks they will consider in depth. The stocks selected from the initial step are now valued to determine their intrinsic value using both asset based and cash-flow-based valuation approaches. Finally, they make a decision to invest only in stocks that are truly undervalued, namely stocks that meet the required margin of safety.

Academics who showed that value investing was dead focused only on the initial step of the value-investing process, which includes all lowest P/E or P/B stocks. But a stock can have a low P/E or P/B simply because it is a bad stock. Value investors can still find undervalued stocks to invest in even if, on average, all low P/E or P/B stocks do not do well.

Are investment advisors worth it?

The third thing to remember, active managers have difficulty outperforming in a rapidly rising market. This is mostly because active managers hold large amounts of cash, especially as the market gets more and more expensive, which makes them underperform in a rapidly rising market. Whereas the index is always fully invested.

And fourth, the S&P 500, Nasdaq and other indexes are hard competitors to beat to start with. This is because normally (and regularly) problem companies are replaced in the index with companies with better financials and performance. In other words, active managers always compete with the best group of companies that the particular index contains. And active managers have to beat this “best-stocks” index after fees and after all other costs associated with running an active fund.

So, let’s be fair and give credit where credit is due and stop active-manager bashing. Skill does matter. Active management is not doomed. Good active managers will survive and will keep making a good living out of active management, especially in an environment of increased volatility in the months and years ahead.

Slow economic growth around the world, particularly in China, as well as a slowdown in productivity, lower population growth, aging baby boomers, higher taxes, higher inflation/interest rates and lower government spending will lead to an increase in stock-market volatility. An expensive market will also contribute to rising volatility, both realized and expected.

In this environment, active managers, such as value investors, will shine.

George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, University of Western Ontario.