The Tortoise and the hare

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The Two Sides of Value

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'Price is what you pay, value is what you get' – Warren Buffet

I have lost count of the number of flights I have boarded over the course of my life. Today, unfortunately, is yet another occasion that I have suffered from delays. Though some of you may be part of the lucky crowd, I am sure that the majority of you reading this will have found yourselves in a similar situation. At least this time my ticket was a real bargain. Previously flights cost two or three times as much and nonetheless I still suffered from the same delays. In other words, I cannot confirm any strong link between the price I paid, and the value of the good I received for it.

It is part of our everyday life that we make decisions about the goods and services we want, and the prices we are happy to pay for them. For example, we perform some quick mental math that, if buying one bottle of wine for £10 versus buying two bottles on a "buy one, get one free" offer, the latter purchase is twice as good as the former. In the world of investment management, relating price information to fundamental data is called valuation.

When you hear that US equities are expensive, or that emerging markets are cheap, someone has looked at the respective current prices for all securities that are components of market indices and compared them with data released by the companies that make up the respective index. Data such as earnings, book values or dividends is used to calculate price earnings (P/E) multiples, price to book ratios or dividend yields (dividends divided by price). Is this the same as value investing? Yes and No!

Though the same ratios are considered, the decision is taken with respect to an individual stock. Is Apple expensive? Is Tesco cheap? Value investing is broadly understood to be a stock selection exercise, not a market timing one. Benjamin Graham was one of the earliest and widely known investors (his 1949 book "The Intelligent Investor" is an evergreen hit), whoput value investing at the very centre of his investment decision making process. These days the most commonly quoted name, when asked for an example of a value investor, is Warren Buffet. Over the next few paragraphs I will look at the rationale for value investing from two different angles, a risk based argument and a behavioural based point of view.

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Everybody knows that buying something cheap and selling it for a higher price creates a profit. So why are we not all Warren Buffets and Benjamin Grahams? It turns out that the really tricky part lies within determining the true intrinsic value of a company that its security price is supposed to reflect. An investor is buying the expectation of all profits that will be generated and all dividends that will be paid in the future. Now, looking into the future is not a simple task by any means, like weather forecasts illustrate to us on a regular basis. This is where financial theory is attempting to help.

A gentleman by the name of Eugene Fama developed a theoretical framework in 1970 known as the Efficient Market Hypothesis (EMH). It assumes that investors, at all times, have access to all available information about a company and its security; and that they have homogenous expectations and act rationally. And so according to the theory, the current price is the best possible predictor of the future, and financial markets are completely efficient. The practical implications of EMH are wonderful. Investors cannot outsmart the market, and so the best way to invest is not to attempt to beat the market but instead to invest passively at the lowest possible cost. The model is brilliant and earned Eugene Fama a Nobel Prize in 2013. Now, billions of dollars are passively tracking various equity and fixed income market indices.

In 1977 the EMH was tested with P/E ratio data. To avoid that the test outcome is not just reflecting the fortune or misfortune of a single company, researchers analyse groups containing dozens of securities that exhibit very similar characteristics. The results of the test showed that the group of stocks with the lowest P/E ratios outperformed groups of securities with higher P/E ratios and, most importantly, also the market. The value premium was born and because applying the EMH would not lead one to expect to be able to generate such premium, the term 'value anomaly' also became part of the admittedly sometimes confusing and overwhelming, financial vocabulary. Many academics then joined the search for an explanation of this anomaly. From Eugene Fama's point of view, you can only earn an additional premium over the market premium for value stocks, if there is an additional risk. In his work with Ken French, published in 1993, he observed that prices of value stocks move together and he argues the reason to be a common macro risk factor. Often this risk is argued to be financial distress or illiquidity.

Finance at the end of the day is a social, and not a hard science like physics. It is therefore very possible that financial markets work differently than modelled in the EMH. The same year the Nobel Prize committee announced Fama to be one of the winners for Economics, Robert Shiller also won that prize. He argues that markets are inefficient and predictable. Shiller is arguably the biggest name in the section of academic finance called behavioural finance. He does not believe that investors act as rationally as assumed in the EMH. Many of his thoughts are captured in his famous book "Irrational exuberance". You might have heard about some of the terms coming out of behavioural finance such as "herding", "overconfidence" or "overreaction to news". Financial market bubbles like the Technology/Media/ Telecommunication (TMT) stock prize bubbles are prime examples of market participants' behaviour leading prices of whole market segments away from company fundamentals.

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It is therefore entirely reasonable to also search for the explanation of the value anomaly by looking at investor behaviour, and in 1994 academics provided evidence in support of this alternative thesis. Later, other authors became more specific, making the case that growth stocks, or non-value stocks, underperform value stocks because they are overvalued due to ill motivated Wall Street analysts and the impact of financial media.

This is a good time to stop and take stock: Why am I telling you all of this? For starters, I hope some readers have learned something new. It also allows me to share some of my own conclusions.

1. Value investing is very intuitive to understand as we perform similar mental accounting regularly in our daily lives.

2. Even on a Nobel Prize winning level, people disagree in the way they attempt to model the real world. Finance at the end of the day is not a hard science.

3. The continued existence of the value premium can be argued very well from two different angles. Such strong, theoretical rationale is absolutely critical for any decision to pursue value investing.

4. Fama and French researched other return premia that they believe are likely to be the result of investors being compensated for an additional risk, such as the small cap premium. But once you allow yourself to broaden your search for other return premia, by also looking for anomalies that are a result of investor behaviour which is the Shiller school of thought, the opportunity set broadens.