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Value investing works. Why isn't it more popular?

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Value investors such as Warren Buffett and Prem Watsa are vastly successful, so why don't more mainstream money managers follow their investing style?

A big reason is that what value investors do is not well known or understood because universities accept the notion that markets are efficient and, as a result, they focus on teaching and applying modern portfolio theory, which cannot be more different from value investing.

Value investing is a style of investing developed in the early 1930s by Ben Graham at Columbia University and involves a three step process – even though most people believe the process is limited to only the first step. First, screen stocks based on price-to-earnings (P/E), price-to-book (P/B) or other valuation related metrics in order to identify possibly undervalued stocks. Second, evaluate the low P/E or P/B stocks 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 (normally around 30 per cent). Value investors are very careful of valuation risk, which is paying too much. They are contrarian, bottom-up stock pickers, with a long-term perspective.

Does value investing work? Are Mr. Buffett and Mr. Watsa the exception rather than the rule? In answering this question, academic research focused primarily on the first step of screening. It found that value stocks outperform growth stocks in global markets. They outperform when the markets go down and when they go up. And they do all this without having higher risk, as measured by beta or standard deviation.

This flies in the face of market efficiency, which advocates that risk and return go together.

Other academic research, better focused on the process value investors follow, also showed that value investing works. Marcin Kacperczyk, Clemens Sialm and Lu Zheng, and Prof. Kacperczyk and Amit Seru, in two papers published in the prestigious Journal of Finance, examined whether skilled managers exist.

The researchers studied about 1,700 actively managed U.S. funds from 1984 to 1999 and 1993-2002, respectively. They found that the more concentrated and less diversified a fund was, the better it did. The outperformance resulted from selecting the right sectors or stocks, not from market timing. They

also found that the lower the reliance on public information and the greater the reliance on a portfolio manager's own skill, the greater the outperformance.

Value investing is all about concentrating a portfolio on a few, selected, truly undervalued stocks. Diversification does not matter much; the margin of safety, which helps identify a stock as truly undervalued, protects the downside and controls for risk.

As noted investor Sir John Templeton said: "It is impossible to produce a superior performance unless you do something different from the majority." That is precisely what value investors do.

Again, this goes against the teachings of modern portfolio theory, whose main tenets are that everyone holds a well-diversified portfolio and that the only risk that really matters is beta. Value investors do not believe that beta or standard deviation or volatility, the cornerstones of modern portfolio theory, are true measures of risk. Risk for value investors is the possibility of losing capital.

This brings us back to the original question: If the evidence in favour of value investing is so overwhelming, why isn't everyone a value investor? Why does a value premium (showing that value, on average, beats growth investing) still exist? This is because the driving forces behind the value premium are human psychology and institutional biases – forces, again, that fly in the face of market efficiency.

Individuals are subject to irrational behaviour. They extrapolate, they are overly optimistic, they overreact and most importantly, they act as a herd. They herd to protect their jobs. If the group loses and a portfolio manager is in the losing group, his job is protected – but if he is wrong and others win while he loses, then his job and reputation are at stake.

Portfolio managers do not lack stock-picking abilities, but are subject to institutional factors that encourage them to overdiversify to protect their jobs and assets under management.

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