Why value investors have the edge in the short term

By George Athanassakos
August 5, 2015 – *The Globe and Mail*

Are markets efficient? Do stock prices discount all publicly available information, correctly and accurately? Is the only way to earn higher returns to take higher risk? It all depends who you ask. Academics who study and teach modern portfolio theory will say, "Of course markets are efficient." But practitioners who put their money where their mouths are and make a living this way, they will say, "Of course markets are not efficient."

If you side with academics, you must invest in index funds, and if you side with practitioners, you should invest in stock pickers and actively managed portfolios managed by portfolio managers who aspire to beat the index.

But are academics that different from, say, value investors? In fact, they are not. They both believe that markets are efficient in the long run. Where they disagree is whether the market is efficient in the short run. And if you look at it this way, one cannot seriously think that markets are efficient in the shorter term.

Market efficiency originated at the University of Chicago, where academics in the 1970s produced research which demonstrated that markets were efficient. Stock picking at that point started to lose its lustre. But fortunately for stock pickers, other academics in the 1980s started to produce research which showed that there were predictable patterns in stock prices, such as the January Effect and the "sell in May and go away" effect, and that different strategies produced unusually high returns even after adjusting for risk, such as the size effect, the value effect, the volatility effect and so on.

At the same time, other market participants also started to become vocal against market efficiency.

Respected value investor Martin Whitman of Third Avenue penned recently: "There is a belief that securities markets reflect price equilibrium … and prices of securities are right. What nonsense!"

Warren Buffett has indicated that he is willing to endow chairs to academics to teach market efficiency so that "more people would sell what he buys and buy what he sells." Nobel Prize winner Robert Shiller once called market efficiency "one of the most remarkable errors in the history of economic thought."

Vernon Smith, an experimental economist – and another Nobel laureate – demonstrated with his experiments that "people do not normally buy and sell based on fundamentals. People are momentum traders trying to buy low and sell high – a process that, repeated enough times, must eventually end in crashes." Moreover, he showed that "the savvy traders took bidding above fundamental worth and generated a bubble equal to the bubbles produced by novices."

Two forces make markets deviate from fundamentals in the short run. They are weaknesses in human nature and institutional biases, both of which are assumed away by modern portfolio theory.

But research by psychologists has concluded beyond any doubt that humans are not rational, particularly when it comes to investing. Humans naively extrapolate past performance, they are overoptimistic and overconfident about their abilities, and they herd. Moreover, they panic when markets go down and are driven by euphoria and greed when the markets go up.

In a recent study by BlackRock, researchers found that while the average equity mutual fund in the United States had an average return

of 8 per cent over the past 20 years, investors in these funds made only 2 per cent. The reason is that they bought high and sold low as they swung back and forth between panic and greed. Such human behaviour makes prices deviate significantly from fundamental value in the short run, giving an opportunity to stock pickers to outperform.

At the same time, professional portfolio managers have conflicts when they manage other people's money, which make them rebalance their portfolios and window dress in an effort to affect their Christmas bonus, which also biases stock prices leading to the January Effect and related calendar anomalies. Moreover, conflicts prevent portfolio managers from doing the right thing, as their key priority is to not lose their job and not lose funds under management, and so the safest thing for them to do is to herd and gravitate toward the index; they become closet indexers. It is such behaviour that prevents them from outperforming.

If, however, one looks at funds which invest in concentrated portfolios and/or deviate significantly from benchmarks, these funds tend to outperform, according to recent academic studies. The outperformance resulted from selecting the right sectors or stocks, not from market timing. In other words, fund managers underperform the index not because they lack stock-picking abilities, but rather because institutional factors force them to overdiversify.

So are markets efficient? You should be the judge.

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