End the Myth! On Value Investing's Incompatibility with Austrian Economics

Michael Olbrich
Saarland University
Email: olbrich@iwp.uni-saarland.de

David J. Rapp
Saarland University
Email: rapp@iwp.uni-saarland.de

Christoph Venitz
Saarland University
Email: venitz@iwp.uni-saarland.de

The failure of mainstream strategies in the recent financial crisis, allied with the success of value investors like Warren Buffett, has meant the value investing strategy has recently attracted an extraordinary volume of attention. Several Austrian economists have focused on value investing and unanimously adjudged it to be a useful strategy, and one that is aligned with Austrian economics. Unfortunately, the scope of previous research is limited to identifying the main common ground between value investing and Austrian economics, particularly the crucial distinction between value and price, whereas potential discrepancies have not yet been revealed. In order to investigate whether value investing is indeed friend or foe to Austrian economics, it is crucial to analyze how these discrepancies potentially affect the compatibility of the two concepts.

Value investing and how it is perceived in Austrian literature

The intellectual roots of the investment strategy termed value investing can be traced back to Benjamin Graham who is credited with being the "father" (Lowe 1996, 1; Montier 2010, 1; Athanassakos 2011, 96) and even the "high priest" (Buffett and Clark 1999, 27) of value investing, while his coauthored book "Security Analysis" (Graham and Dodd 2009) has been described as value investing's "bible" (Vick 1999, 1; Damodaran 2012, 5; Dreman 2012, 46).[1] In essence, value investing distinguishes an asset's intrinsic value from its market price and recommends investing in the asset as long as the intrinsic value exceeds the asset's price, accordingly if its price exceeds its value the asset would be considered an unwise investment (e.g., Hagstrom 1999; Vick 1999; Greenwald et al. 2001; Kwag and Lee 2006). The main idea is that intrinsic value and market price might differ but will coincide eventually.[2] Therefore, the concept of an intrinsic value is at the core of value investing. Originally, the intrinsic value was defined as the "value which is justified by the facts, *e.g.*, the assets, earnings, dividends, definite prospects, as distinct, let us say, from market quotations established by artificial manipulation or distorted by psychological excesses" (Graham and Dodd 2009, 64). While comparing an asset's intrinsic value to its market price, value investors demand a margin of safety—usually between 20 % and 50 % of the intrinsic value—to protect their financial engagement against unexpected (adverse) future developments (Greenwald et al. 2001; Graham 2003; Athanassakos 2011; Leber 2011; Damodaran 2012). Therefore, the comparison between an asset's intrinsic value and its market price (given a margin of safety) is key to the value investing concept.

To date, several Austrian economists have dealt with value investing. E.g., Taghizadegan, Stöferle, and Valek (2014, 225) concluded that "most widely, value investing's approach is in line with the Austrian approach"[3] and Leithner (2005, 3) agreed, stating that value investors and Austrian economists "hold compatible views about a range of fundamental economic and financial phenomena." Furthermore, Spitznagel (2013, 269) characterized Austrian investing "as value investing's intellectual forerunner" while Grimm (2012, 223) summarized that value investing—as "an important application of fundamental analysis"—typically receives a "favorable treatment" by Austrian authors. Moreover, the principles of value investing and Austrian economists' findings are combined and applied in practice, so for example, some investment companies—e.g., Polleit & Riechert Investment Management LLP (2015)—base their investment decisions on a combination of both value investing and Austrian economics. In addition, various institutions—like the Institute for Austrian Asset Management (2015)—conduct research on the interrelations between value investing and Austrian economics. Apparently, the Austrian community—represented by both academics and practitioners dealing with value investing—has unanimously concluded that value investing and Austrian economics are compatible.

However, this insight is solely based on the analysis of the existing common ground shared

1 In fact, some authors portray value investing as more than just an investment strategy; e.g., Buffett and Clark (1999) titled their book "Buffettology", which implies a certain form of cult.

2 For the possibility of disparities between value and price as well as the "inherent tendency for these disparities to correct themselves" see Graham and Dodd (2009, 69 et seq.).

3 Unless otherwise noted, all translations are by the authors.

by value investing and Austrian economics. Previous research exclusively focuses on three main aspects, namely the distinction between value and price; the attitude to neoclassical finance theory; and the application of mathematical models. However, a diligent attempt to determine whether value investing is compatible with Austrian economics would have to look beyond previous research, which owing to its focusing exclusively on common ground seems neither sufficient nor meaningful.

Value investing from an Austrian perspective—friend or foe?

The distinction between value and price is undoubtedly the most crucial common ground between value investing and Austrian economics and, consequently, is highlighted in existing research (e.g., Leithner 2005; Taghizadegan, Stöferle, and Valek 2014). This differentiation is certainly indispensable, especially because—given a permanent value-price-congruence—market participants cannot increase their wealth by means of transactions and, therefore, each economic action is pointless (Hering 2000; Olbrich 2000; Olbrich and Rapp 2012; Hering 2014).[4] Furthermore, value investors necessarily have to distinguish between values and prices, since the concept of value investing would otherwise be superfluous (e.g., Schredelseker 2013).

In addition, both value investing and Austrian economics reject neoclassical finance theory, especially due to its assumptions and the implications flowing from them, such as those concerning the relation between value and price,[5] which run contrary to the principles of both value investing and Austrian economics. Given the highly restrictive and escapist assumptions (especially that there is a perfect, frictionless market environment) that underpin finance theory, value and price actually coincide by definition (Hering 2014; Olbrich, Quill, and Rapp 2015).[6] In contrast to neoclassical finance theory, both value investing and Austrian economics take a real world perspective rather than an entirely hypothetical one and, consequently, reject finance theory.

Finally, value investors and Austrian economists hold a compatible view on the application of complex mathematical models, which they both consider to be overemphasized. According to value investing literature, the investment calculus should be kept quite plain and be based on simplifying assumptions (e.g., steady future benefits).[7] Graham (1958, 20) stated that in "44 years of Wall Street experience and study I have never seen dependable calculations made about common-stock values, or related investment policies, that went beyond simple arithmetic or the most elementary algebra." This insight led Graham to conclude that when higher algebra is introduced "you could take it as a warning signal that the operator was trying to substitute theory for

4 Menger (2007) emphasizes that the desire to reach an improved economic position causes any transaction.

5 E.g., Buffett (1997) argues that to "invest successfully, you need not understand beta, efficient markets, modern portfolio theory, option pricing or emerging markets. You may, in fact, be better off knowing nothing of these." Similarly, Austrian economists "have frequently criticized neoclassical economics for the unrealistic character of its assumptions" (Long 2006, 3) and have analyzed existing differences between both schools of thought (e.g., Huerta de Soto 1998).

6 For a critical perspective on the restrictive and escapist assumptions of neoclassical finance theory see Hering (2000), Matschke and Brösel (2013), Hering (2014), Hering and Toll (2015), Olbrich, Quill, and Rapp (2015).

7 E.g., Leithner (2009, 9) points out that "followers of Graham ground their analysis in simple maths, clear logic and hard evidence" and that the "investor-businessman distrusts the advanced mathematics, statistical models and computations which underlie contemporary finance."

experience." Austrian economists also avoid the application of complex mathematical models, especially because while such models are adequate when dealing with equilibrium constellations, they cannot express the essence of real economic phenomena and entrepreneurial creativity (Huerta de Soto 1998). In consequence, both value investing and Austrian economics refute the application of complex mathematical models and its overemphasis in mainstream economics.

Prior research does illustrate an apparent compatibility between value investing and Austrian economics. However, that research has contented itself with examining the major common ground and has therefore misled Austrian economists over the extent of compatibility between value investing and Austrian economics. Clearly, focusing only on common ground while omitting existing discrepancies is not sufficient, and the scope of the analysis must be extended to the distinguishing features. In so doing, four problem areas appear. While the first identified difference is mainly semantic and could easily be harmonized, the other issues reveal value investing's irremediable incompatibility with Austrian economics. The four problem areas are:

1. Valuation versus appraisement
2. Irrationality versus rationality
3. Intrinsic value versus subjective value
4. Reliable past versus uncertain future

First, the terms "valuation" and "appraisement" are applied differently in value investing and Austrian economics.[8] To Austrian economists, valuation reflects a ranking of goods on an ordinal scale, while appraisement aims at anticipating future market prices and, therefore, needs to be conducted ahead of valuation (e.g., Herbener and Rapp 2016). Unlike Austrian economics, value investing does not differentiate between valuation and appraisement at all; indeed, some value investors, including Graham himself, use both terms synonymously. However, aiming to assess intrinsic value (by estimating future benefits) must be characterized as appraisement rather than valuation.

Second, according to value investing literature, value-price differences in particular can be traced back to market participants' irrational behavior (Hagstrom 1999; Vick, 1999). As an illustration, Graham (2003) created the allegorical figure of the manic depressive *Mr. Market*, whose investment decisions are solely based on his heavily swaying mood and are made independently of real (economic) changes. In contrast to that and according to Mises (1998, 18), "[h]uman action is necessarily always rational," consequently, from an Austrian perspective, *irrational behavior* is an oxymoron while *rational behavior* must be seen as a pleonasm. Hence, value investors blame irrational behavior for value-price differences whereas in Austrian economics, irrational behavior is impossible by definition. At first glance, this issue might seem to be a more or less conceptual difference; in fact, the diverse insights on (ir)rational behavior reveal entirely different mindsets concerning the market process, particularly the price formation aspect. According to value investing, intrinsic values and market prices should *theoretically* be coincident; the fact that they are not in *reality* is primarily explained by market participants' irrationality.

8 For the differentiation between valuation and appraisement see in detail Mises (1998). See further Smith (1971), and Olbrich, Quill, and Rapp (2015).

Therefore, value investing resembles neoclassical finance theory rather than Austrian economics in this respect, since neoclassical finance theory also works on the assumption that values equal prices (Brösel, Toll, and Zimmermann 2011; Kruschwitz and Löffler 2015). According to Austrian economics, values and prices necessarily have to be different, both in theory and practice. That Austrian view holds that market prices result from transactions between market participants who differ in their valuations and try to improve their level of wealth by means of transaction, that is, for the purchaser by paying less for, or for the seller by earning more for the good than it is worth to them. Consequently, the characterization of market participants as irrational is not only a semantical issue; it exposes the entirely different understanding of the market process held by value investors and Austrian economists.

Third, Austrian economics is based upon methodological individualism and subjectivism;[9] as Huerta de Soto (1998, 77) puts it, the "real human being of flesh and blood" is the starting point for Austrian thinking. Consequently, Austrian economists are well aware of the fact that eventually the preferences, ends, and means of real human beings determine their *subjective* valuations and corresponding actions. According to Austrian economics, each good will usually hold a different value to different individuals and—depending on the point in time—a different value to the very same individual. In contrast, even though value investors do reject neoclassical finance theory's view of a *permanent* value-price-conformity, they do not dismiss the concept of an objective value. The intrinsic value is by definition an objective value; it is inherent in the appraised asset, depersonalized, and therefore, entirely independent of any actual individual and his ends and means. Semantically, the term *intrinsic,* along with other terms used by value investors—like *fair*, *fundamental* or, in particular, *objective* value—indicate the rejection of subjectivism. Therefore, value investing and Austrian economics hold entirely incompatible views on the nature of value.

Lastly, a crucial difference exists between value investing and Austrian economics with regard to the significance of a future-orientation in decision-making. In value investing, the appraisal and, consequently, the investment decision is regularly based on past or (at best) present data to avoid the issue of dealing with uncertainty in a future-oriented process.[10] For example, value investor Montier (2009, 49) argues that "forecasting is a waste of time" and even a "task beyond Hercules himself" (Montier 2009, 55). Since value investors (commonly) focus on past or present data to bypass the issue of dealing with uncertainty, they misjudge the significance of future-orientation in any decision process. In contrast, Austrian economics stresses the significance of future-orientation in decision-making, despite the issue of uncertainty.[11] Indeed, Austrian economics—unlike value investing—does not surrender in the face of this issue but instead confronts it. For example, Taghizadegan, Stöferle, and Valek (2014) criticize the extrapolation of past performance as investors' number one mistake. Herbener (1992, 80) concludes that

9 Horwitz (1994, 17) states that subjectivity is "the fundamental tenet that distinguishes Austrians from neoclassicism." Similarly, Huerta de Soto (1998, 76 et seq.) lists subjectivism as one of various "essential differences between the Austrian and neoclassical schools."

10 Graham and Dodd (2009, 68 et seq.) characterize "the uncertainties of the future" as one of the main handicaps for security analysis.

11 In this respect, Mises (1998, 105 et seq.) highlights that "the future is hidden" and, therefore, every action is "a risky speculation."

uncertainty "calls forth the skill of entrepreneurship in each action a person takes." Obviously, Austrian economists acknowledge the importance of a future-orientation in decision-making, and accordingly confront the problem of uncertainty rather than trying to bypass it as the foundations of value investing do.

Conclusions

Recently, value investing has attracted a great deal of attention owing to the failure of classic models in the financial crisis and to value investors' successful investments, including from several Austrian economists, who have unanimously identified a compatibility between value investing and Austrian economics. Essentially, value investing focuses on the comparison of a good's intrinsic value and its market price and recommends investing in it as long as the asset's value exceeds its price (given a margin of safety). Admittedly, value investing and Austrian economics do share some basic insights, especially the crucial distinction between values and prices. However, value investing and Austrian economics are nevertheless entirely incompatible, particularly given that value investing's definition of value contradicts the Austrian value concept. Due to the incompatible characteristics of both concepts, the attributed compatibility must be characterized as a myth. To ensure the compatibility with Austrian economics, an appraisal concept necessarily has to take crucial Austrian features into account, especially the subjective nature of value, a future-oriented perspective, and an individual consideration of uncertainty. These requirements are *only* met by appraisals based upon investment theory.[12]

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12 For investment-theory based appraisals see especially Olbrich, Quill, and Rapp (2015), Rapp (2015), and Herbener and Rapp (2016).

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