BESTINVER
Asset Management

Value Investing and the Austrian School of Economics

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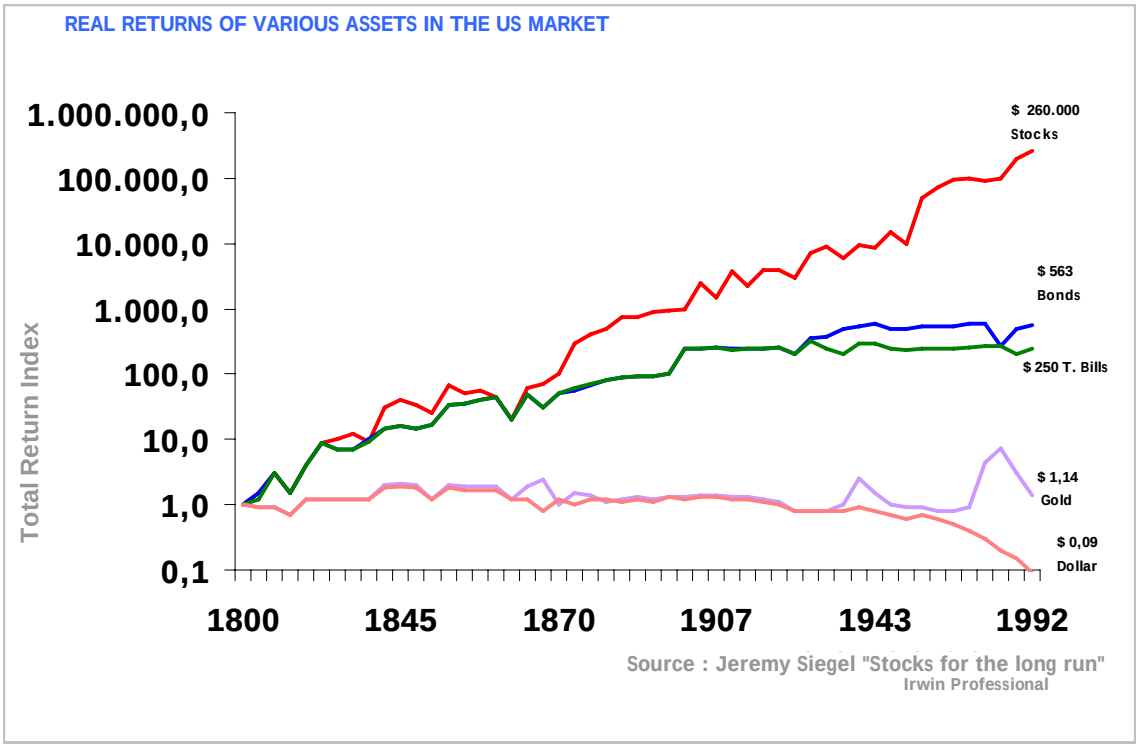
Historically, investing in stocks has been more profitable than investing in gold, government debt and bonds. (figure 1).

Figure 1: Stocks are the most profitable in the long term



However, obtaining sustained returns in the long term can be a tricky process. Proof of this is the fact that 80% of professional equity managers don not beat the market. For individual investors the panorama is not much better: their proclivity to make mistakes is so high, that over the course of history, highly advanced metrics have been developed to measure private investor enthusiasm, and are calibrated to give a sell signal just when this enthusiasm hits its peak and vice versa.

This takes us to a very simple question that very few people ask themselves:

How can equity be the best investing option if, both professionals and individuals have bad track records?

… and another simpler question:

What can be done to take advantage of higher returns from equity investments?

These questions have already been answered on numerous occasions by the founding fathers of Value Investing (Benjamin Graham, Warren Buffet, and Peter Lynch). When asked how they were able to consistently obtain annual returns of 20% for long periods

of time (figure 2), they simply explained **what they did in practice**. I think that an explanation from the Value Investing point of view, which is anchored in concepts from the Austrian School of Economics, could help us understand much better what has already been explained so well by others. In short, it can help as a guide to a better understanding of how we invest at Bestinver and why.

Figure 2: There are people who systematically outperform the market.

FUND MANAGER	AVG. ANNUAL AVERAGE	NUMBER OF YEARS	ANNUAL RETURNS VS. INDEX
WARREN BUFFETT (Berkshire)	21.10%	42	10.80%
PACIFIC PARTNERS	23.60%	19	15.80%
STAN PERLMETER	19.00%	18	12.00%
SEQUOIA FUND	18.20%	14	9.00%
WALTER SCHLOSS	16.10%	28	8.70%
TWEEDY BROWNE	16.00%	15	8.20%
CHARLES MUNGER	13.70%	14	7.70%
BESTINVER*	19.32%	15	7.59%

30/05/2008 * The returns refer to Bestinfond, our oldest equity mutual fund

1. Why the "Academy" is fatally flawed

Investing in stocks is not SCIENTIFIC in the same way as measuring the cause of traffic accidents or chemical reactions in a laboratory. Stocks of companies whose businesses prosper, tend to go up, whereas not prosperous businesses make stocks fall down.

Companies are managed by individuals who carry out an array of *human actions* over time, driven by a wide range of reasons. Furthermore, businesses exist in an environment that is in constant flux, the outcome of an infinite number of actions by other individuals. Therefore a business flourishes or goes to the wall depending on the correct or incorrect decisions of the people running it, as well as many other exogenous factors caused by an infinite array of HUMAN ACTIONS (which may affect, for example, interest rates, oil prices, and an infinite number of other variables). However, what is clear, is that the company performance ***can't be modelled,*** or completely reflected using mathematics or statistics, because it doesn't belong to the realm of science, but rather, to that of Human Actions.

Nevertheless, the most prestigious universities in the world insist on teaching the CAPM (Capital Asset Pricing Model), which is nowadays accepted everywhere as the academic cornerstone for asset valuation. The following is the Wikipedia definition:

***Capital Asset Pricing Model**, or **CAPM** is a model frequently used in finance. It suggests that the higher the risk entailed in investing in an asset, the greater the return should be on this asset to compensate for this increase in risk. The model was developed, among others, by William Sharpe, rewarded with the Nobel Prize in Economics.*

The excess yield of a risky asset can be expressed in relation to a benchmark portfolio's yield – the market portfolio, for example, the most representative stock market indices – adjusted for a risk coefficient beta, which indicates the risk of the individual asset vs. the market risk.

The CAPM is expressed as follows:

$$E(r_j) = r_f + \beta_{jm} E(r_m - r_f)$$

Where:

- *$E(r_j)$ is the expected return on the capital asset j.*
- *β_{jm} is our beta coefficient, or also*

$$\beta_{jm} = \frac{Cov(r_j, r_m)}{Var(r_m)}$$ *, and*

- *$E(r_m - r_f)$ is the risk premium.*
- *(r_m) Return of the market.*
- *(r_f) Risk free rate of return.*

A quick look at Wikipedia is all it takes to confirm that the creators of CAPM consider as a SCIENCE what in reality is HUMAN ACTIVITY. This is the fatal flaw that explains the failures of all the professional investors who follow this particular model.
The attractive possibility of forecasting the future of equities using math, statistics and other scientific tools, has led to the development of quantitative and technical analysis (charts); as well as using hundreds of "magic" algorithms which, once again, confuse SCIENCE with HUMAN ACTIVITY.

The performance of companies that prosper or fail cannot be captured by mathematical models or graphs, because Human Actions are what determine their fate. Therefore, these actions are, by definition, richer, more varied and more at random than anything science can foresee.

2. Uncertainty is the most important factor when investing in stocks

Due to the unfathomable nature of human actions, it should be kept in mind when investing in stocks that the only constant factor is change and therefore uncertainty. This uncertainty cannot be reduced to its minimum level through a "portfolio efficient frontier", or an ideal stock portfolio composed of stocks selected for their risk levels as measured by the stock's standard deviation vs. the market (Beta). Once again the theory tries to convince us that something that 5is not measurable (uncertainty) can be measured (risk).

If, upon investing in the stock market we take this into account, that uncertainty exists and will always exist. This is due to the fact that human activity never stops. The next logical question, in my opinion, would be:

Can I obtain a degree of security that will protect me from the intrinsic uncertainty of Human Activity?

The uncertainty facing the stock market investor is twofold. In one hand, there is the danger that the company he or she invests in might fail instead of prosper. The other is that of making an investment right before a long ***"bear"*** market, or not investing right before a long ***"bull"*** market. It does not take a Nobel Prize to realize that the dilemma can be solved by

- investing in many stocks instead of a few
- distributing the investment over time

And, as is always the case when talking about equities, Warren Buffet has already weighed in:

"Buy a low-cost index fund, and try to put Money at work in different times to prevent buying at a market top" (Statement from the Berkshire Hathaway General Shareholder Meeting, 2008, Max Olson)

3. Another way of managing risk

Lets imagine a carnival show featuring two thousand "gifted" chimpanzees in a coin-flipping contest.After the coin has been tossed many times, there are 15 chimpanzees that have guessed correctly 100% of the time. As it turns out these 15 chimpanzees come from the same zoo. Obviously, we'd all like to know what the primates are fed in this zoo, and who their trainers are. (Rough summary of "The super-investors of Graham and Doddsville", by Mr. Dodd.)

Well, Table 2 shows that this special zoo actually exists, and that it systematically hires managers that have outperformed the indices by wide margins for long periods of time. Bestinver is that zoo. And there is an explanation. I firmly believe that **we deal with uncertainty in a different manner**.

We operate on the basis that whenever we invest (not speculate) in a company, we are buying a piece of the business, renouncing to the other possible potential investments we could make with the money; in favor of the expectation that we will end up with a greater amount of money in the future. (Benjamin Graham, "The Intelligent Investor").

Following the Austrian School terminology ", whenever we invest in a company, we are placing our trust in the capacity of the company's management team to create value. This is the equivalent of placing our trust in their abilities to foresee a series of "human actions" (those of competitors, clients, suppliers, regulatory authorities, employees, etc.) with the ending goal of increasing the value of their company.

It seems logical that in this framework, **the main source of uncertainty has to do with the company's management team.** Focusing on this point, will bring us far closer to the reality of the situation than any mathematical model could possibly do. There is no model that is 100% accurate because Human Action is richer in possibilities than what Science can measure. But recognizing that uncertainty comes from people is already a big advantage.

At Bestinver, we consider important to meet the management teams of the companies we invest in, as well as those of the competition and all the individuals that interact with the company on a daily basis (employees, suppliers, clients, etc.).Without knowing and analyzing these stakeholders, it is impossible to understand the business the company is into. Therefore, two out of the three key components for making an investment are the BUSINESS (which must be understandable) and the MANAGEMENT TEAM (it must be honest, capable, exercise sound operating practices and have strong capital management skills).

But we would be contradicting ourselves if we thought that a careful study of the factors mentioned above, could lower our risk levels to zero. All the risks mentioned before, are derived from the unpredictable nature and constant change generated by the HUMAN ACTION.

And it is precisely for this reason that we want to face this uncertainty with an ADDITIONAL MARGIN OF SAFETY, by understanding the business and assuring ourselves of the quality of its managers. We seek this MARGIN OF SAFETY by paying much less for a business than what we think it is worth. Once again, we turn to the father of Value Investing, Benjamin Graham, for whom the 3 most important words in financial investments are: "**Margin of Safety"**.

The idea that a thing may have an intrinsic value (in this case, a business) which is quite different from its market value, is in contrast to the subjective nature of the Human Action. In fact, it could be argued that there is no such thing as an "**intrinsic value**", but rather, thousands of individual perceptions of value coordinated by the market. This, in the end, would give us the current PRICE.

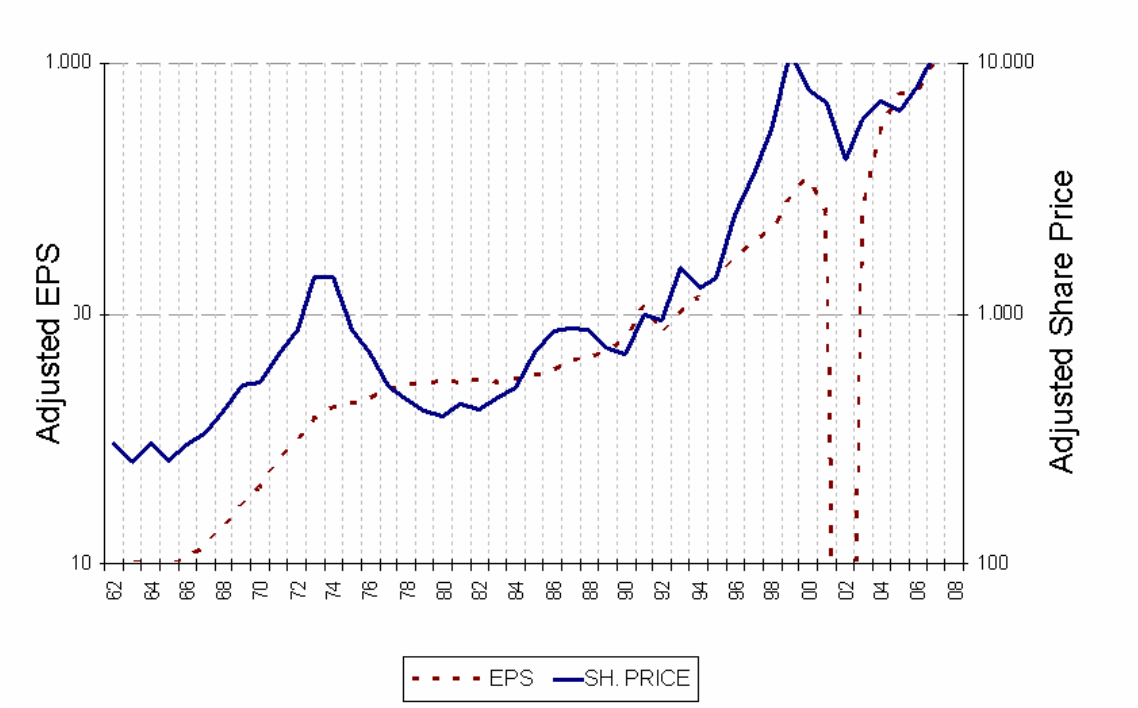
However, Austrian Praxeology (which explains historical events by looking at the motives behind the actions of the main players) can be applied to Wall Street.

Many would agree with me that the stock market is a great business for the endless middlemen who live off to commissions (brokers, managers, corporate bankers), and whose main motivation is SELLING, instead of generating wealth for their clients. All these people encourage speculation, creates "bubbles", and generates the false hope that "you can make an annual return of 20% on the market relatively quickly"; which, in the end, generates confusion in clients. As Buffet explained, the market in the short run is a "voting machine" whereas, in the long run, it is a "weighting machine". In short, it is irrational and excessive in the short run, and represents a good measure for valuating companies in the long run(figure 3).

Proof of this is that the private equity market has not had even a fraction of the volatility seen in normal equity markets. An owner who is going to sell his entire business to another individual is less likely to "make a mistake" due to psychological factors which

might feed his ambitions or fears. Using praxeology it becomes apparent why, when entire unlisted companies are sold, their price does not fluctuate as much as stocks do. Like Buffet said, "*There's no free lunch in the private markets" (quote from Berkshire Hathaway General Shareholder Meeting 2008, Max Olson)*

Figure 3: Long-term share prices reflect value



The Austrian theory of Human Action explains why there are irrational "bubbles" in the market while also indicating the correct path going forward (and not just some "magic formula!").

It is worth looking up Murray Rothbard´s ***History of Money and Banking in the United States*** and his theory on the historical reasons behind dollar depreciation events. No mathematical model could forecast how individuals are likely to react when faced with all the incentives in place at any given moment in time (premium/punishment).

This paper does not intend to explain how we obtain the intrinsic value of a company , but to go into explaining why the short-term market price cannot be taken as a gospel truth. Neither does it contain "all the known information at any given time"; in fact, it is only the result of the sum of individual perceptions largely shaped by psychological factors, which are encouraged by the huge Wall Street selling machine...

Is what we are doing scientific? Absolutely not

Spending numerous hours and a great deal of effort in understanding a business, many more hours on business trips to meet with management teams and competitors BY NO MEANS guarantee success. Nor is it a formula which when applied by two different people will lead to the same conclusion.

In all the years we have been working as advisors we have witnessed many unpredictable human actions (such as a price war between two companies with the same margins), as well as other actions (the majority) which are fairly predictable: capacity

increases in the most efficient company in its sector to seize market share from others, disposing of a businesses which is generating losses, management share buybacks when shares are undervalued, etc…).

We have also noticed that family businesses are better at protecting a firm's value than those that are managed by directors which have no stake in the capital. Once again, using Austrian Praxeology, perhaps the incentives for people who risk their own money are "healthier" than the incentives for those who only risk shareholders' money. In addition, many of these latter individuals enjoy a certain degree of anonymity.

This is **NOT** a **FORMULA**. It is not a science. It does, however, focus the efforts in the right place, on Human Action. It attempts to scrutinize people managing companies rather than plotting them into mathematical models. We also must be aware that, given the intrinsic uncertainty surrounding Human Action, there is a margin of error that cannot be minimized with "Betas". It does, however, provide a degree of security by revealing significant undervaluations. Therefore, it is necessary to avoid the "fashionable and expensive" trend just because Wall Street expounds on it.

Those who claim that the Value Investing School is superior to the rest would like for **all** of its followers to outperform the market. However, this is not true.
Only **a few** have managed to do this through time on a constant basis, and those who have had a winning formula which was, possibly without even realizing it, keeping up with the Human Action. However, the winning formula by itself does not guarantee success, it is a necessary component but it is not enough. The key additional element, I dare say, is closer to art than it is to science.