

VALUE INVESTING'S COMPATIBILITY WITH AUSTRIAN ECONOMICS—TRUTH OR MYTH?

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ABSTRACT: Within the Austrian economists' community, value investing is characterized as a useful investment strategy, and one that is in line with Austrian economics, in particular Austrian value theory. In fact, value investing shares some basic findings with Austrian value theory, especially the crucial distinction between values and prices. However, value investing also contradicts some fundamentals of Austrian economics. Therefore, the authors argue that value investing's seeming compatibility with Austrian economics must be characterized as a myth. The aim of this article is to illustrate what makes value investing incompatible with Austrian economics and, hence, to terminate this myth.

KEYWORDS: Value investing, Austrian economics, value theory, intrinsic value, subjectivism

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1. VALUE INVESTING AND AUSTRIAN ECONOMICS—BLOOD BROTHERS IN FACT?

The recent financial crisis and its serious impacts on global (stock) markets raised a multitude of questions concerning market participants' appraisals and corresponding investment decisions. Moreover, the failure of mainstream investment strategies, allied with the successful financial undertakings of well-known value investors like Warren Buffett and his holding company Berkshire Hathaway, has meant that value investing has attracted an extraordinary volume of attention. Several Austrian economists have focused on value investing and unanimously judged it to be a useful strategy and, moreover, characterized it as being aligned with the Austrian school of thought. However, this conclusion is a fallacy because, unfortunately, the scope of prior research has been limited to the main common ground shared by value investing and Austrian economics—especially the crucial distinction between an asset's value and its price—while possible discrepancies have not been revealed yet. Since these discrepancies might affect the compatibility of the two concepts, an assessment of whether value investing is indeed friend or foe to Austrian economics requires an analysis of both common ground *and* existing discrepancies. The current article addresses this gap. To provide a sound basis, the article proceeds with a brief presentation of value investing's conceptual framework and offers an outline of the current Austrian view of this investment strategy in Section 2. In order to provide a comprehensive judgment of the relationship between value investing and Austrian economics, Section 3 enhances current research by analyzing both the common ground and the discrepancies. Section 4 of the article provides a conclusion summarizing its insights.

2. VALUE INVESTING AND HOW IT IS PERCEIVED IN AUSTRIAN LITERATURE

2.1 Conceptual Framework of Value Investing

Value investing's intellectual roots can be traced back to Benjamin Graham—a former Columbia University professor—who is credited with being the "father" (Lowe, 1996, p. 1; Leithner, 2009a, p. 28; Montier, 2010, p. 1; Athanassakos, 2011, p. 96; Spitznagel, 2013,

p. 270) of value investing.¹ Moreover, his coauthored book “Security Analysis”—first published in 1934—has been characterized as value investing’s “bible”² (Vick, 1999, p. 1; Brandes Investment Partners, 2009, p. 1; Damodaran, 2012a, p. 5; Dreman, 2012, p. 46).³ In essence, value investors compare an asset’s intrinsic value to its market price and recommend investing in the asset as long as the value exceeds the price; accordingly if the value falls below the price, the asset would not be considered a wise investment (e.g., Hagstrom, 1999, pp. 20–21; Kwag and Lee, 2006, p. 64; Calandro, 2009, pp. 1–2; Truong, 2009, p. 1; Grimm, 2012, pp. 228–229; Panyagometh, 2012, pp. 20–21; Hagstrom, 2014, pp. 64–65; Otte and Castner, 2014, p. 21). It is value investing’s main idea that *in the short term*, intrinsic value and market price might differ but *in the long term* they will eventually coincide.⁴ Therefore, the concept of an intrinsic value is key to the value investing strategy. Originally, Graham and Dodd (2009, p. 64) defined the intrinsic value 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.”⁵ In order to protect their investments against unexpected (adverse) future developments and potential misjudgments respectively, value investors demand a margin of safety—usually between 20 percent and 50 percent of the intrinsic value—when comparing an

¹ Buffett and Clark (1999, p. 27) even recognize Graham as “Wall Street’s high priest of investment philosophy.”

² Similarly, Carlisle (2014, p. x) characterizes this textbook as “the foundational document for the school of investing now known as *value investing*.” In fact, value investing is sometimes portrayed as more than just an investment strategy; for example, Buffett and Clark (1999) title their book “Buffettology” and, therefore, imply a certain form of cult.

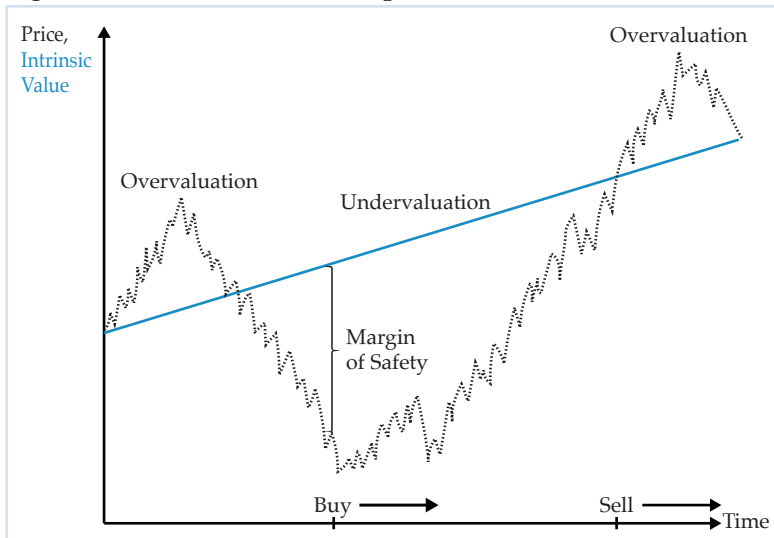
³ Since there is a close connection between value investing and fundamental analysis (e.g., Grimm (2012, p. 223) states that value investing “is often affiliated with fundamental analysis” while Kaza (2000, p. 60) and Chang (2011, p. 99) even credit Graham with being the father of fundamental analysis), this paper’s insights also refer to fundamental analysis in general.

⁴ For the possibility of disparities between intrinsic value and market price and the “inherent tendency for these disparities to correct themselves” see in particular Graham and Dodd (2009, pp. 69–70) and further Greenwald et al. (2001, p. 3), Leithner (2009a, p. 2), Schredelseker (2013, p. 222), and Hagstrom (2014, p. 64).

⁵ In general, value investing literature either does not define the intrinsic value or makes use of the above mentioned definition (e.g., Lowe, 1996, p. 20; Schredelseker, 2013, pp. 221–222).

asset's value to its price (Lowe, 1996, p. 13; Greenwald et al., 2001, p. 4; Graham, 2003, p. 518; Calandro, 2009, p. 2; Athanassakos, 2012, p. 1).⁶ Finally, if the asset's price equals or even exceeds its intrinsic value, that is, the asset is overvalued, value investors suggest it be sold (e.g., Ye, 2013, p. 1; Hagstrom, 2014, p. 137; Otte and Castner, 2014, p. 41). Consequently, the value investing process can be broken down as follows:⁷ First, as a preselection, the investor has to identify possibly undervalued companies and classify them as potential acquisition targets. Subsequently, those companies' intrinsic values have to be computed in order to finalize the investment decisions. The following figure—similarly used by Vick (1999, p. 49), Brandes Investment Partners (2009, p. 3), Schredelseker (2013, p. 223), Otte and Castner (2014, p. 40)—illustrates this procedure:⁸

Figure 1: The relation between price and intrinsic value



⁶ In this respect, Graham (2003, p. 518) states that the margin of safety “is available for absorbing the effect of miscalculations or worse than average luck.” According to Gad (2009, p. 95), “Warren Buffett likes to invest with a 50 percent margin of safety.”

⁷ Both Athanassakos (2012, p. 1) and Howard (2015, p. 91) agree, distinguishing between a preselection (e.g., based on a ratio analysis) and the subsequent question “if the stock is indeed undervalued” (Howard, 2015, p. 91).

⁸ If an investor aims to sell the asset only when the price exceeds the intrinsic value by a certain percentage, the selling-point in Figure 1 slips to the right on the x-axis.

2.2 The Current Austrian View on Value Investing

In the Austrian literature, several authors deal with value investing, for example Leithner (2005, p. 3) states “that value investors and Austrian School economists hold compatible views about a range of fundamental economic and financial phenomena” and, similarly, Taghizadegan, Stöferle, and Valek (2014, p. 225) conclude that “very broadly, value investing’s approach is in line with the Austrian approach.”⁹ Spitznagel (2013, p. 269) sympathizes with this view, characterizing Austrian investing “as value investing’s intellectual forerunner” while Grimm (2012, p. 223) ultimately summarizes that value investing—as “an important application of fundamental analysis”—typically receives “favorable treatment” in the Austrian literature.¹⁰ Moreover, the principles and findings of both value investing and Austrian economics are combined and applied in practice: For example, some investment companies—including Polleit and Riechert Investment Management LLP (2015)¹¹—consider outcomes derived from both concepts when making investment decisions. Additionally, various institutions—such as the Institute for Austrian Asset Management (2015)—take into account the interrelations between value investing and Austrian economics. Evidently, both academics and practitioners representing the Austrian community unanimously conclude that value investing’s insights are (very broadly) compatible with those of Austrian economics. However, this conclusion is fallacious since it is based solely on the one-sided analysis of the existing common ground shared by value investing

⁹ Unless otherwise noted, all translations are by the authors. Taghizadegan, Stöferle, and Valek (2014, p. 8) further present a personal linkage; they argue that Warren Buffett’s father was influenced by Austrian economists and passed some important Austrian ideas on to his son. For this personal linkage see further Calandro (2009, p. 228) whose book “Applied Value Investing” also refers to both value investing and Austrian economics. Moreover, in a Mises Daily Article, Mayer (2000) characterizes “the great Benjamin Graham” as “inestimably wise.”

¹⁰ Krug and Mohelsky (2010, p. 34) share this conclusion, stating that “in principle, value investing accurately reflects Austrian economics’ philosophy.”

¹¹ Similarly, Leithner and Company Pty. Ltd. (2016), a private investment company, “adheres strictly to the traditional ‘value’ approach to investment pioneered by Benjamin Graham” and is—at least—associated with Austrian economics since Leithner (2009a, p. 19) states that “Leithner & Co. has no crystal ball, but it does have the insights of the Austrian School.”

and Austrian economics while omitting potential discrepancies. The analysis has led prior research to focus on three main aspects, namely the distinction between value and price, the attitude to neoclassical finance theory, and the application of mathematical models. Indeed, since existing discrepancies possibly influence the compatibility, “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” (Olbrich, Rapp, and Venitz, 2016, p. 38).

3. VALUE INVESTING FROM AN AUSTRIAN PERSPECTIVE—FRIEND OR FOE?

3.1 What Do Value Investing and Austrian Economics Have in Common?

3.1.1 The Distinction between Value and Price

Undoubtedly, their distinguishing between values and prices represents the most crucial common ground of value investing and Austrian economics and, therefore, is highlighted by both practitioners and academics (e.g., Leithner, 2005, p. 5; Taghizadegan, Stöferle, and Valek, 2014, p. 255; Haaker, 2015, p. 221). This differentiation is certainly indispensable not only for (value) investing purposes but for economic action in general because the assumption of a permanent value-price-congruence creates a market environment that deprives market participants of the option to increase their wealth through conducting transactions. Under these conditions, every action would be pointless and, therefore, individuals would have no economic incentive to act (Hering, 2000, p. 441; Olbrich, 2000, p. 460; Olbrich and Rapp, 2012, p. 233; Hering, 2014, p. 9).¹² Furthermore, if value investors did not distinguish between values and prices, there would never be an opportunity for a value investment and, consequently, the concept of value investing would be superfluous (e.g., Schredelseker,

¹² Austrian economists (e.g., Menger, 2007, p. 191; Hochreiter, 2008, p. 3; Taghizadegan, Stöferle, and Valek, 2014, p. 17) agree, emphasizing that the pursuit to upgrade the level of wealth is the root cause of any transaction.

2013, p. 222). However, while both value investing and Austrian economics highlight the possibility of value-price-disparities, their assumptions and findings differ significantly, especially since value investors unlike Austrian economists hold the view that the market price has an inherent tendency to converge toward the intrinsic value.¹³ Moreover, the value investing process is limited to listed companies and prohibits investment in unlisted companies as well as the accompanying (price) negotiations. Consequently, value investing's applicability is limited to a (very) small section of the investment universe. Furthermore, while taking over the majority of shares, the investor has to take into account the increase in share prices resulting from the growth in demand (e.g., Hering, 2014, pp. 208–209). Indeed, value investors hold the view that the intrinsic value of a single share corresponds pro rata to the value of the business as a whole (e.g., Leithner, 2005, p. 6). However, it is not feasible to obtain the value of a single share by dividing the value of the entire business by the total number of shares issued (e.g., Olbrich, 2000, p. 460; Olbrich and Rapp, 2012, p. 235).

3.1.2 Rejection of Neoclassical Finance Theory

The highly restrictive and escapist assumptions that underpin neoclassical finance theory—especially that holding that there is a perfect, frictionless market environment—and the implications flowing from them, such as those concerning the relation between value and price, run contrary to the principles of value investing and Austrian economics; therefore, both concepts reject neoclassical finance theory and the application of models springing from it in practice. On this topic 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.” Equally, Austrian economists “have frequently criticized neoclassical economics for the unrealistic character of its assumptions” (Long, 2006, p. 3) and have analyzed existing characteristics distinguishing neoclassical finance theory from Austrian economics (e.g., Huerta de Soto, 1998). In fact, given neoclassical finance theory's assumptions and the idealized market

¹³ For this view see the references already cited in footnote 4.

environment flowing from them, value and price actually coincide by definition (Hering, 2014, p. 214; Olbrich, Quill, and Rapp, 2015, p. 12).¹⁴ Indeed, the idea of a permanent value-price-equilibrium is neither consistent with the Austrian view nor with that of value investing since both concepts take a real world perspective rather than the—entirely hypothetical—neoclassical one. However, value investing analysis is characterized by inaccuracy, especially since value investors usually only highlight their refusal of the efficient market hypothesis while omitting some further—and even more restrictive—neoclassical assumptions.¹⁵ For example, focusing on the capital asset pricing model (CAPM), value investors primarily criticize the inherent definition of risk¹⁶ rather than other underlying assumptions which make the CAPM entirely detached from reality (such as homogenous expectations, information symmetry, and also no restrictions on lending).¹⁷ But given that value investors presume that market efficiency alone results in a market environment characterized by a permanent value-price-congruence,¹⁸ their line of reasoning is at least comprehensible since such an environment implies the absence of profitable (value) investment opportunities and runs contrary to value investing's theoretical foundation. While

¹⁴ For a critical perspective on the restrictive and escapist assumptions of neoclassical finance theory see Hering (2000, pp. 441–447), Hering and Toll (2015, pp. 14–15), and Olbrich, Quill, and Rapp (2015, pp. 9–15).

¹⁵ For Buffett's rejection of the efficient market hypothesis see Rajablu (2011, p. 3). Within the efficient market hypothesis, Fama (1970, p. 383) distinguishes between weak, semi-strong and strong information efficiency. For efficient market considerations see further Copeland, Weston, and Shastri (2005, pp. 353–355), and Perridon, Steiner, and Rathgeber (2017, pp. 231–232).

¹⁶ As cited in Hagstrom (2014, p. 66), "Buffett thinks the whole idea that price volatility is a measure of risk is nonsense" and Buffett (1994) himself states that "the academics' definition of risk is far off the mark." Most interestingly, even though value investors exclusively criticize CAPM's definition of risk, they themselves do not provide any precise alternative. For example, Vick (1999, p. 233) claims that "investors create risk by chasing stocks indiscriminately, by failing to do their homework."

¹⁷ For those restrictive and escapist assumptions see for example Campbell, Lo, and McKinlay (1997, pp. 181–183), Copeland, Weston, and Shastri (2005, pp. 147–148), Hering (2015, p. 297), and Perridon, Steiner, and Rathgeber (2017, p. 290). In value investing literature, only few authors criticize these assumptions (e.g., Whitman, 1999, pp. 34–37; Montier, 2009, pp. 19–28).

¹⁸ Value investing literature suggests this interpretation since for example Greenwald et al. (2001, p. 148) argue that the idea of market efficiency is "that the market always incorporates the best estimate of the true value of a security."

a perfect capital market in fact includes information efficiency it has further implications. Consequently, an efficient capital market need not necessarily be a perfect one, but information efficiency is a criterion for the existence of a perfect capital market (e.g., Schredelseker, 2013, p. 372).¹⁹ Nevertheless, the rejection of neoclassical finance theory conforms to the Austrian view and, therefore, can be identified as further common ground. However, Austrian economists' insights into the characteristics of neoclassical finance theory are far more profound than those of the advocates of value investing, that is because Austrian economists do not only conduct research on market efficiency (e.g., Campos Dias de Sousa and Howden (2015, p. 389) conclude that "the efficient market hypothesis is not only incorrect, but unnecessary")²⁰ but also question the idea of market equilibrium (e.g., Yeager, 1997, p. 154; Huerta de Soto, 1998, p. 77),²¹ perfect competition (e.g., Block, Barnett, and Wood, 2002), and criticize neoclassical economists for their "frequent assumption of no uncertainty" (Herbener, 1992, p. 81).

3.1.3 Rejection of the Overemphasized Application of Mathematical Models

Finally, complex mathematical models are badly received by value investors and Austrian economists alike because they both consider their application to be overemphasized (Leithner, 2005, pp. 5–9; Taghizadegan, Stöferle, and Valek, 2014, pp. 254–255). Value investing actually calls for a quite plain investment calculus, which—for simplification purposes—should be based on simplified assumptions, such as, steady future benefits. For example, Graham (1958, p. 20) states 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,

¹⁹ For the relationship between perfect capital markets and efficient capital markets, see also Copeland, Weston, and Shastri (2005, p. 354), who state that "[c]apital market efficiency is much less restrictive than the notion of perfect capital markets."

²⁰ For shortcomings of the efficient market hypothesis see also Pasour (1989) and Shostak (1997).

²¹ See also Austrian economist Jacobson's (1992, p. 788) argument that "[m]arket imperfections or inefficiencies allow a market to be in disequilibrium and are responsible for profit opportunities."

that went beyond simple arithmetic or the most elementary algebra” and concludes that if higher algebra is introduced, “you could take it as a warning signal that the operator was trying to substitute theory for experience.” Similarly, Leithner (2009a, p. 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.” Austrian economists hold a compatible view on the application of mathematical models since such models are exclusively adequate when dealing with equilibrium constellations as neoclassical economists do, but they do not include significant features of Austrian economics’ analytical reasoning like the essence of real economic phenomena and entrepreneurial creativity (Huerta de Soto, 1998, p. 84).²² In fact, due to the “mainstream abuses of mathematics, including the frequent merely decorative and pretentious use of symbols, some Austrians have wanted to ban mathematics from economics” (Yeager, 1997, p. 155).²³ In this respect, Mises (1998, p. 347) concludes that the mathematical method “is an entirely vicious method, starting from false assumptions and leading to fallacious inferences.” However, value investors cannot entirely bypass mathematical formalism since the absolute rejection of mathematics contradicts the need of calculating intrinsic value being the “core task for [value] investors” (Hagstrom, 1999, p. 20).

3.2 Why Are Value Investing and Austrian Economics Nevertheless Incompatible?

3.2.1 Valuation versus Appraisalment

Prior research finds a strong compatibility between value investing and Austrian economics. However, that research has

²² Therefore, Huerta de Soto uses “mathematical formalism” as a distinguishing feature between Austrian economics and the neoclassical schools. Vaughn (1994, pp. 1–2) agrees, pointing out that “Austrians do avoid expressing their ideas in mathematical symbols” and that the “[a]version to mathematics and free market advocacy are distinctively Austrian traits.”

²³ For considerations concerning the benefits and costs of mathematization with regard to Austrian economics see Hudik (2014).

misled Austrian economists over the extent of compatibility because it exclusively directs attention to the major common ground while to date existing discrepancies have been omitted. Obviously, this procedure is not sufficient and, therefore, the scope of the analysis must be extended to the distinguishing features of the two approaches. In doing so, four problem areas arise; one mainly semantic issue that could be easily harmonized and three serious ones forming an insurmountable barrier between the two concepts. The four problem areas are:

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

First, it is important to focus on the terms *valuation* and *appraisalment* and their application because unlike value investors, Austrian economists explicitly differentiate between those terms and their specific meaning.²⁴ In Austrian economics, *valuation* describes a ranking of goods on an ordinal scale, whereas *appraisalment* aims at predicting the structure of future market prices; consequently, appraisalment is a necessary step toward an economizing valuation in a division of labor economy (e.g., Herbener and Rapp, 2016, p. 5). Furthermore, Herbener and Rapp (2016, pp. 5–6) recently introduced the term *investment appraisal* in the Austrian literature, describing a forward-looking decision tool for the use of the valuing person.²⁵ In contrast, value investors do not differentiate between appraisalment, investment appraisal, and valuation at all and typically refer to the term *valuation*. Indeed, some of them—especially Graham (2003) himself—use different terms synonymously. However, value investing's approach to assessing intrinsic value (which is by means of estimating future benefits) encompasses appraisalment and investment appraisal rather than valuation.

²⁴ For the differentiation between valuation and appraisalment see in detail Mises (1998, pp. 328–330) as well as Smith (1969, pp. 3–6), Smith (1971, pp. 67–68), and Herbener and Rapp (2016, pp. 4–5).

²⁵ For the meaning of investment appraisal and its relation to valuation and appraisalment see Herbener and Rapp (2016, pp. 5–12).

3.2.2 Irrationality versus Rationality

Second, value investing primarily explains value-price-differences by way of market participants' irrational behavior (Hagstrom, 1999, pp. 141–160; Vick, 1999, pp. 41–55; Brandes Investment Partners, 2009, pp. 1–2; Athanassakos, 2012, p. 1; Otte and Castner, 2014, pp. 27–28).²⁶ As an illustration, Graham (2003, pp. 204–205) created the allegorical figure of the manic depressive—or at least “emotionally unstable” (Hagstrom, 2014, p. 182)—Mr. Market whose investment decisions are solely based on his heavily swaying mood while he neglects to consider real (economic) changes.²⁷ Sometimes, the intrinsic value of an asset coincides with the market price determined by Mr. Market but usually “Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly” (Graham, 2003, p. 205). Therefore, the value investors' challenge is to take advantage of this erratic behavior; that is to invest when the offered price falls (far) below intrinsic value.²⁸ In contrast to that and according to Mises (1998, p. 18) “[h]uman action is necessarily always rational.” Consequently, in the Austrian view, *irrational* behavior is impossible by definition; hence, *rational* behavior must be seen as a pleonasm.²⁹ In turn, since every action aims to satisfy individual desires and “nobody is in the position to substitute his own value judgments for those of the acting individual” (Mises, 1998, p. 18), irrational behavior must be characterized as an

²⁶ Basically, Vick (1999, p. 45) argues that most of the time, the stock market “is neither ordinary, rational nor fair” while Graham and Dodd (2009, p. 68) characterize “the irrational behavior of the market” as one of the main handicaps for security analysis.

²⁷ Greenwald et al. (2001, p. 159) describe Mr. Market as “alias for the collectivity of investors.” For more on the allegorical Mr. Market see also Buffett (1988), Lowe (1994, pp. 83–84), Greenwald et al. (2001, p. 3), Leithner (2009b, pp. 5–6), Lowe (2010, pp. 38–39), Hagstrom (2014, pp. 181–182), and Otte and Castner (2014, p. 61).

²⁸ This view on other market participants and their investment decisions reveals the self-assessment of the proponents of value investing since—in their opinion—value investors can overrule other market participants due to their irrational behavior and value investing's superior character.

²⁹ Schreiber (1965, pp. 21–23) referring to Mises's findings concludes that it is impossible to objectively define rational behavior.

oxymoron.³⁰ Whereas—at first sight—this difference might seem to be primarily conceptual, the diverse insights on (ir)rational behavior reveal entirely different mindsets concerning the market process in general, and in particular the price formation aspect. Unlike Austrian economics, value investing holds the view that intrinsic values and market prices should *theoretically* be coincident (e.g., Gottwald, 2011, p. 38); and in order to explain the fact that in *reality* they are not, value investors accuse market participants of acting irrationally. Due to neoclassical finance theory's assumption of a value-price-conformity (e.g., Brösel, Toll, and Zimmermann, 2011, p. 282; Kruschwitz and Löffler, 2015, p. 176), value investing resembles finance theory rather than Austrian economics in this respect.³¹ In contrast, and according to both Austrian practitioners and academics, values and prices necessarily have to be different in general. In the Austrian view, a specific market price results from a transaction between market participants differing in their valuations and pursuing a higher level of wealth. In order to meet this objective by means of a transaction, the purchaser has to pay less for and the seller to earn more for the asset than it is subjectively worth to each respective party.

3.2.3 Intrinsic Value versus Subjective Value

Third, Austrian economists' insights are based on methodological individualism and subjectivism,³² as Yeager (1987, p. 5)

³⁰ In this context, Callahan (2004, pp. 37–38) presents the example of a guy called Rich who is stranded on a desert island; to survive, Rich has to eat some of the rats populating the island. However, Rich follows a religion that rejects harming living creatures and, therefore, he only eats coconuts even though without eating the rats, he is doomed to die. Unlike other economic schools, Austrian economics does not at all characterize this behavior as irrational; Rich simply pursues his highest goal, which is to live by his religious commitment.

³¹ This insight also applies to the terms under- and over*valuation* as well as under- and over*pricing* and their application by value investors because in this respect, value investing resembles neoclassical finance theory rather than Austrian economics since both use these terms synonymously. However, in fact, markets do not value but price the traded assets.

³² For subjective value theory see Menger (2007, pp. 145–149) emphasizing “that value is nothing inherent in goods” (p. 145) and that the “*measure* of value is entirely subjective in nature” (p. 146). See further Horwitz (1994, pp. 17–22),

puts it, “[e]conomists of the Austrian school put special emphasis on subjectivism.” Therefore, “economics is primarily about people and their purposes, not about things and quantities” (Yeager, 1997, p. 155). Huerta de Soto (1998, p. 77) agrees, stating that “the real human being of flesh and blood” forms the bedrock of Austrian thinking. This subjectivity builds “the fundamental tenet that distinguishes Austrians from neoclassicism” (Horwitz, 1994, p. 17).³³ Obviously, that Austrian view holds that real human beings’ individual preferences, ends, and means determine their *subjective* valuations and, ultimately, their corresponding actions. Consequently, Austrian economics acknowledges the fact that each good will usually hold a different value for different individuals and that an individual’s perception of value is liable to change as time passes. Compared to the insights of Austrian economics, value investing’s considerations regarding the terms *value* and *price*, as well as their meaning, are very wide of the mark. Granted, value investing’s rejection of the neoclassical idea of a *permanent* value-price-conformity has to be acknowledged. Unfortunately, value investing exclusively focuses on finance theory’s assumptions and the implications flowing from them without dismissing the fundamental neoclassical value concept of an objective depersonalized value. Indeed, some value investors may disagree, arguing that intrinsic value takes into account subjective features:³⁴ For example, Buffett (1995) concludes that anyone “calculating intrinsic value necessarily comes up with a highly subjective figure that will change both as estimates of future cash flows are revised and as interest rates move.”³⁵ Obviously, Buffett

Langlois (1994, p. 118), Yeager (1997, pp. 154–155), Huerta de Soto (1998, p. 77), Callahan (2004, pp. 25–26, 43–44), and Mises (2008, p. 18).

³³ Similarly, Huerta de Soto (1998, pp. 76–77) presents subjectivism as one of various “essential differences between the Austrian and neoclassical schools.”

³⁴ Apparently, Graham and Dodd themselves are not sure about their own value concept since in their opinion, “intrinsic value is an elusive concept” (Graham and Dodd, 2009, p. 64). Similarly, Buffett (1995) refers to intrinsic value’s “fuzziness.”

³⁵ Damodaran (2012a, p. 41)—while describing an investment strategy he calls “activist value investing”—also strongly suggests a dependency between the asset’s value and the controlling owner. In detail, Damodaran (2012a, p. 41) states that a company “could be worth more to someone else because of synergy.” Rather strange is that Damodaran (2012b, p. 1) simultaneously takes a contrary position, claiming that it is “disingenuous [...] to argue that value is in the eye of

does not aim to calculate a subjective value but instead characterizes subjectivity as a *troublemaker* that hinders the calculation of intrinsic value. Apparently, the idea of an objective value prevails. Value investing's insights into the relationship between value and price and its reasoning related to existing discrepancies support this conclusion: Value investors blame irrational behavior for discrepancies between values and prices whereas their assimilation owes more to (more) rational behavior. In turn, given that market participants act rationally, their investment appraisals must result in the same (intrinsic) value; obviously, the influence of individual preferences, ends, and means is omitted. Moreover, if the intrinsic value was a subjective figure, whose value judgment would be the one to cause the market price to oscillate? Semantically, the term *intrinsic* as well as other terms used by value investors—especially *fair*, *fundamental*, or *objective* value—are already indicative of the rejection of subjectivism (Olbrich, Rapp, and Venitz, 2016, p. 40). Since intrinsic value is supposed to be inherent in the appraised asset and entirely independent of any actual individual and his ends and means, the value investing and Austrian economics views on the nature of value are entirely incompatible.³⁶

3.2.4 Reliable Past versus Uncertain Future

Lastly, value investing and Austrian economics take diametrically opposed positions over the significance of a future-orientation in decision making. In order to bypass the issue of dealing with uncertainty in a future-oriented process, value investors usually base their investment calculus and, consequently, the investment decision on past or (at best) present data.³⁷ For example, value investor Montier (2009, p. 49) claims “that forecasting is a waste of time” if not “a task beyond Hercules himself” (Montier, 2009,

the beholder” and that the idea “that any price can be justified if there are other investors willing to pay that price” is “patently absurd.”

³⁶ Inconsistently, Schmidt (1976, p. 68) argues that one cannot presume that a Graham-and-Dodd-investment totally abstracts from the valuing subject but that individual features of a specific valuing subject are not taken into account.

³⁷ Graham and Dodd (2009, pp. 68–69) classify “the uncertainties of the future” as an essential handicap for security analysis.

p. 55).³⁸ Graham himself is also skeptical of investment decisions based upon future prospects; in his opinion, the combination of the formulae needed to calculate the present value of an asset “with highly imprecise assumptions can be used to establish, or rather to justify, practically any value one wishes” (Graham, 1958, p. 17). Greenwald et al. (2001, pp. 35) support this insight, referring to the “skepticism with which Graham and Dodd investors regard present value calculations of future cash flows” while Bos (2013, p. 19) emphasizes that “deep value investing is much more concerned with the actual facts of a company than forward-looking announcements.” Furthermore, Graham and Dodd (2009, p. 109) argue that for “investment, the future is essentially something to be guarded against rather than to be profited from.” They use a future-orientation to differentiate between investment and speculation; unlike investment, speculation is based on “prospective developments that differ from past performance.” Indeed, some value investors when working on a present-value-based appraisal, not only estimate payment flows by focusing on past data but also adjust the discount rate by adding a premium for “risk.”³⁹ As a result, uncertainty is considered threefold: First, by applying seemingly certain past benefits; second, by adding a risk premium to the discount rate and third, by insisting on a margin of safety. Therefore, profitable investments may be dismissed.⁴⁰ Again, Austrian economists take a contrary position regarding the need for future-orientation in decision-making by stressing

³⁸ Indeed, Montier (2009, pp. 47–55) admits that theoretically, an investment calculus based on future cash flows is the correct way to determine an asset’s value but dismisses this procedure because “the implementation becomes a minefield of problems” (p. 47). Therefore, Montier emphasizes the need for investment appraisals based on past data.

³⁹ E.g., Greenwald et al. (2001, p. 98) hold the view that the “riskier the investment, the higher the cost of capital should be.” In contrast, as cited in Damodaran (2012a, p. 11), Buffett does not add a risk premium because he uses “conservative estimates of earnings.” One might refer to such a procedure as the “certainty equivalent approach” whereas the “risk premium approach” demands adding a risk premium to the denominator. For a presentation of both certainty equivalent approach and risk premium approach as well as their failings see Matschke and Brösel (2013, pp. 175–178).

⁴⁰ For the infeasibility of using both the certainty equivalent approach and the risk premium approach simultaneously see Olbrich and Rapp (2012, p. 235).

its significance, despite the issue of uncertainty.⁴¹ In this regard, Mises (1998, pp. 105–106) emphasizes that “the future is hidden” and, therefore, every action is “a risky speculation.” Pasour (1989, p. 96) agrees, stating that in “reality, information about the future is always imperfect.”⁴² Indeed, Austrian economists confront the uncertainty rather than surrender in the face of it. For example, Taghizadegan, Stöferle, and Valek (2014, p. 17) debunk the extrapolation of past performance—as recommended by value investor Montier—labeling it investors’ number one mistake,⁴³ while Herbener (1992, p. 80) points out that uncertainty “calls forth the skill of entrepreneurship in each action a person takes.”⁴⁴ Value investing misjudges the significance of a future-orientation in decision-making while Austrian economics emphasizes and confronts the issue of uncertainty rather than trying to bypass it as the advocates of value investing do.

4. CONCLUSIONS

Due to the failure of neoclassical models in the recent financial crisis and value investors’ (seemingly)⁴⁵ successful investments, the

⁴¹ Münstermann (1966, p. 21) states that “for what has been, the businessman does not pay.” For the significance of a future orientation for investment decisions see for example Berliner (1913, p. 25), Schmalenbach (1917/1918, pp. 1–2 and p. 11), Liebermann (1923, p. 79), Mellerowicz (1926, p. 123), Koch (1939, p. 1364), Mellerowicz (1952, pp. 47–49), Jaensch (1966, p. 23), Schmalenbach (1966, pp. 36–37), Münstermann (1970, pp. 20–21), and Moxter (1983, p. 97).

⁴² Similarly, Hoppe (1997, p. 49) states that our “knowledge of future events and outcomes is less than perfect” and carves out the drastic consequences flowing from a world characterized by “complete certainty” while Holcombe (2017, p.160) concludes that “all entrepreneurial innovation is risky, and there is no way to be certain ahead of time whether an investment will be profitable.” For the problem of uncertainty with explicit regard to future earnings see also Mises (2008, p. 27).

⁴³ Skousen (1994, p. 236) also criticizes the extrapolation of past trends; while referring to the CAPM, he argues that to assume “that Beta coefficients are relatively constant throughout market cycles” would be “a violation of the principle that history never quite repeats itself.”

⁴⁴ With respect to common stock selection, Grimm (2012, p. 224) states that “success depends on the investor’s ability to excel at identifying opportunities for profit in dynamic and uncertain environments.”

⁴⁵ A large number of empirical studies suggests that value investing is a superior investment strategy, especially compared to the growth investing strategy

value investing strategy has attracted a great deal of interest, even among the Austrian community who has concluded that a strong compatibility between value investing and Austrian economics exists. In value investing, the comparison of an asset's intrinsic value and its market price is key to identifying profitable investment opportunities. Given that the asset's intrinsic value exceeds (falls below) its price taking into account a margin of safety, buying (selling) the asset is considered to be a wise decision. Previous research revealed that value investing and Austrian economics do indeed have some basic insights in common. Particularly since both concepts emphasize the crucial distinction between values and prices, the attributed compatibility seems at first sight to be consistent. However, *inter alia* since value investing's definition of value is fundamentally at odds with the Austrian value concept, the seeming compatibility between value investing and Austrian economics must be characterized as a myth. If an appraisal concept is to be useful and compatible with Austrian economics, it must take the crucial features of that approach into account, particularly the subjective nature of value, a future-oriented perspective, and an individual consideration of uncertainty. These conditions are only met by appraisals based upon investment theory.⁴⁶

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(representative see Capaul, Rowley, and Sharpe, 1993; Lakonishok, Shleifer, and Vishny, 1994; Fama and French, 1998; Athanassakos, 2009). In this respect, Fama and French (1998, p. 1975) state that "[v]alue stocks have higher returns than growth stocks in markets around the world" while Athanassakos (2011, p. 86) refers to a "large body of academic research [which] has shown that value stocks [...] tend to have higher average returns than growth stocks." However, those studies cannot mask the theoretical flaws and fallacies of the value investing strategy because they are subject to the problems typical of empirical research. In fact, especially due to the arbitrary definition of the *past* observation period and the arbitrary stock selection, they are—at best—suitable to point out *past* tendencies. While making future investment decisions, the investor should be well aware of the flaws and fallacies of extant empirical research.

⁴⁶ For investment-theory based appraisals see especially Olbrich, Quill, and Rapp (2015), Rapp (2015), and Herbener and Rapp (2016).

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