



Fact, Fiction, and  
Value Investing

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# Fact, Fiction, and Value Investing

## ★ *Bernstein Fabozzi/Jacobs Levy Awards Winner*

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### Overview

Value investing has a long history in the financial markets, with **Benjamin Graham** and **David Dodd** advocating for the strategy in their 1934 classic book *Security Analysis*. It is practiced today by many well-known practitioners, including **Berkshire Hathaway** CEO **Warren Buffett**. Yet, the strategy is subject to a number of faulty beliefs from both adherents and opponents. In an interview with **Institutional Investor Journals**, **Andrea Frazzini** and **Ronen Israel** provide insights into what many get wrong—and right—about value strategies.

Their award-winning research appeared in *The Journal of Portfolio Management*. It was co-written with **AQR Capital Management** colleagues **Cliff Asness** and **Tobias Moskowitz** (who is also a professor at the **University of Chicago Booth School of Business**). Their article—**Fact, Fiction, and Value Investing**—was named Outstanding Article in the **17<sup>th</sup> Annual Bernstein Fabozzi/Jacobs Levy Awards**.

### Practical Applications

- **Look beyond Buffett.** Many believe value investing only works best in a concentrated stock-picking style, similar to Buffett's approach. In fact, a systematic, diversified value strategy also produces strong long-term results.
- **Think beyond equities.** Other asset classes, even currencies and commodities, demonstrate reliable value premiums.
- **Act beyond single strategies.** A system that incorporates value and momentum can boost returns.

### Practical Applications Report

Value investing remains subject to a number of misperceptions, despite dating back to Victorian England and being popularized by Graham and Dodd in the early 20th century. This disconnect between reality and perception became clear to principals at AQR while they were working on a previous article that sought to dispel myths about momentum investing. That article, *Fact, Fiction, and Momentum Investing*, was published in JPM in 2014.




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Cliff is a Founder, Managing Principal and Chief Investment Officer at **AQR Capital Management**. He is an active researcher and has authored articles on a variety of financial topics for many publications, including *The Journal of Portfolio Management*, *Financial Analysts Journal* and *Journal of Finance*.

He has received five **Bernstein Fabozzi/Jacobs Levy Awards** from *The Journal of Portfolio Management*, in 2002, 2004, 2005, 2014 and 2015. The *Financial Analysts Journal* has twice awarded him the **Graham and Dodd Award** for the year's best paper, as well as a Graham and Dodd Excellence Award, the award for the best perspectives piece, and the Graham and Dodd Readers' Choice Award. In 2006, **CFA Institute** presented Cliff with the **James R. Vertin Award**, which is periodically given to individuals who have produced a body of research notable for its relevance and enduring value to investment professionals.

Prior to co-founding AQR Capital Management, he was a managing director and director of quantitative research for the Asset Management Division of Goldman, Sachs & Co. He is on the editorial board of *The Journal of Portfolio Management*, the governing board of the **Courant Institute of Mathematical**



**Finance at New York University**, the board of directors of the **Q-Group** and the board of the **International Rescue Committee**. Cliff holds a BS in economics from the Wharton School and a BS in engineering from the Moore School of Electrical Engineering at the University of Pennsylvania, graduating *summa cum laude* in both. He received an MBA with high honors and a PhD in finance from the University of Chicago, where he was **Eugene Fama**'s student and teaching assistant for two years (so he still feels guilty when trying to beat the market).



## Key Definitions

### Momentum investing

An investment strategy that buys or overweights stocks with high recent returns and underweights or shorts stocks with low recent returns.

### Value investing

An investment strategy that buys or overweights stocks with low prices relative to their fundamentals and underweights or shorts stocks with high prices relative to their fundamentals.

## The Authors

- ✓ Assessed academic research.
- ✓ Evaluated perspectives from the trenches.
- ✓ Incorporated AQR's own empirical analysis.

“We realized that something like value, which has perhaps been talked about and traded on for a longer period time, had an equal number of misunderstandings, and we felt it was the natural thing to try to attack the problem in a similar way,” Israel reports.

The AQR team identified nine myths and unrealized truths about value investing by assessing academic research, evaluating perspectives from the trenches and incorporating their firm's own empirical analysis. The authors point out that even value supporters can spread confusion about the strategy.

You can read about the myths—why they persist and how they are debunked—in the full article. Here are some of them:

- A value portfolio's Sharpe ratio almost doubles when combined with stocks chosen for momentum and profitability.
- An HML-style portfolio (**Fama and French's high minus low**) that uses a composite of four value measures provides similar average returns as those built with just a single value measure, but with 20% less volatility.
- During the past 88 years, the market-adjusted return to value within large-capitalization stocks has only been 1.7% annually, or one-third of the return for small-cap value stocks.

## THE BUFFETT PROBLEM

Warren Buffett became a legend through his success at picking and holding individual cheap stocks and thereby delivering strong, long-term results. Conversely, Buffett has dismissed diversification as “protection against ignorance,” Frazzini, Israel and their co-authors note in the article. They repeat another Buffett quote that elaborates: “It makes little sense if you know what you are doing.”

That feeds into a widespread belief that a successful value investor must eschew diversification in favor of a concentrated number of deeply researched stocks, the authors point out. But in this case, Buffett is promoting a “fiction” about value that won't necessarily benefit investors as a whole, they argue.

“You are always going to find people who did well like Buffett, but that doesn't mean you can't capture value in a systematic way,” Israel says. “A diversified value approach is very valuable in an investor's portfolio.”

Strong, long-term evidence demonstrates that a systematic value approach to diversified assets can provide solid returns over a long period. Buffett's approach is just one aspect of value investing, and limiting oneself to picking idiosyncratic value stocks can add further risks, as well as higher fees, Frazzini and Israel point out.

## THE FLIP SIDE TO BUFFETT

Representing the flip side to Buffett is a group of pure value investors, who claim they aren't using a value strategy. This is an example of an unrealized truth. Their portfolios are labeled with terms such as “fundamental indexing” and “smart beta.” But the authors argue that these approaches that weight by fundamentals—such as book value, dividends and other measures—instead of the market-cap weighting used in traditional indexing are simply implementing a value tilt.



Back-testing a fundamental index, using data from large-cap stocks from 1962 through early 2014, verified this. Fundamental indexing “is capturing the value premium,” Israel notes.

### LOOK BEYOND EQUITIES

Another widely held myth about value investing is that it’s only applicable to equities, which may be tied to the fact that most of the academic literature has focused on stocks, the authors note. But that means that investors may be missing out on applying value to other asset classes.

Frazzini recommends investors revisit a 2013 research paper by Asness, Moskowitz and another AQR colleague (and professor at **New York University’s Stern School of Business**), **Lasse Heje Pedersen**, called *Value and Momentum Everywhere*. It documents significant value return premia in assets including bonds, currencies and commodities from 1972 through 2011.

“Value isn’t just a stock-oriented phenomenon,” Israel says. “That’s a power in understanding value. The fact that it works in so many contexts gives us confidence.”

### A COMPOSITE OF VALUE MEASURES

Aside from applying value principles across asset classes, investors should take an “intuitive” approach to measuring value, the authors recommend. That is, use a composite of variables, Frazzini and Israel explain.

Academia predominantly measures value through the book-to-market ratio, but using multiple measures of value—such as earnings-to-price and cash-flow-to-price ratios—helps produce more stable value portfolios with higher Sharpe ratios and stronger returns, they report.

### RETHINKING LARGE-CAP VALUE

Bucking earlier academic research that relied on data from 1963 to the early 1980s, the authors find that there’s no strong value premium among large-cap stocks when considering a longer, 88-year period. Still, there’s value in the segment. Combining large-cap value with large-cap momentum boosts the Sharpe ratio to close to that seen with the small-cap stocks using a similar mix of value and momentum, Frazzini and Israel report.

“From an investor perspective, putting these things together and taking advantage of multiple factors like momentum and profitability, we think, is the most important thing,” Israel says.

Frazzini adds, “An important point we make is that value should not be considered as a stand-alone strategy.”

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—Andrea Frazzini



## HELICOPTERS, ROCK N' ROLL, FAMILY & TENNIS

Frazzini spends little time away from the world of finance, but he's learning to fly helicopters. He is a guitarist in a band that plays classic rock, such as Rolling Stones songs.

Israel jokes he has limitations that Frazzini doesn't. "First, I'm not Italian, and I have three kids!" He spends his time outside of AQR with his family, and he plays tennis.

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Andrea is a Principal on **AQR Capital Management's** Global Stock Selection team, focusing on research and portfolio management of the firm's long/short and long-only equity strategies.

He is also an Adjunct Professor of Finance at **New York University's Stern School of Business**. He has published in top academic journals and won several awards for his research, including the **Smith Breeden Award**, the **Fama-DFA Prize**, the **BGI best paper award**, several **Bernstein Fabozzi/Jacobs Levy Awards**, and the **PanAgora Crowell Memorial Prize**. Prior to joining AQR, Andrea was an associate professor of finance at the University of Chicago's Graduate School of Business and a research associate at the National Bureau of Economic Research.

He also served as a consultant for DKR Capital Partners and J.P. Morgan Securities and on the board of directors of the Center for Research in Security Prices at the University of Chicago. He earned a BS in economics from the University of Roma Tre, an MS in economics from the London School of Economics and a PhD in economics from Yale University.



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Ronen is a Principal at **AQR Capital Management**. His primary focus is on portfolio management and research. He was instrumental in helping to build AQR's Global Stock Selection group and its initial algorithmic trading capabilities, and he now runs the Global Alternative Premia group, which employs various investing styles across asset classes.

He received an Outstanding Article Award as part of the **17th Annual Bernstein Fabozzi/Jacobs Levy Awards** from *The Journal of Portfolio Management* in 2015 and the Special Distinction Award as part of the **Harry M. Markowitz Prize** for the best paper published in the *Journal of Investment Management* in 2015. He is on the executive board of the University of Pennsylvania's **Jerome Fisher Program in Management and Technology** and is an adjunct professor of finance at **New York University**. Ronen has been a guest speaker at Harvard, Columbia, the University of Pennsylvania and the University of Chicago and is a frequent conference speaker.

Prior to joining AQR, he was a senior analyst at Quantitative Financial Strategies. He holds a BS in economics from the Wharton School at the University of Pennsylvania, a BAS in biomedical science from the University of Pennsylvania's School of Engineering and Applied Science and an MA in mathematics, specializing in mathematical finance, from Columbia University.



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Toby is a Principal at **AQR Capital Management**. He contributes to research on asset pricing and investment issues related to domestic and international strategies for AQR's Global Alternative Premia team. He holds the Fama Family Chaired Professorship in Finance at the **University of Chicago's Booth School of Business** and is a Research Associate at the **National Bureau of Economic Research**.

He has won the **Amundi Smith Breeden Award** for the best paper published in the *Journal of Finance*, the **Brattle Group Prize** for the best corporate finance paper published in the *Journal of Finance*, the **BGI Michael Brennan Award** for the best paper published in the *Review of Financial Studies*, twice, the 2015 **Bernstein Fabozzi/Jacobs Levy Awards** for Outstanding Article in *The Journal of Portfolio Management*. In 2007, he was awarded the **Fischer Black Prize by the American Finance Association**, which recognizes the best financial economist under the age of 40, and the **Ewing Marion Kauffman Prize Medal for Distinguished Research in Entrepreneurship** in 2012 by the Kauffman Foundation, which recognizes the largest contribution to entrepreneurial research under the age of 40.

His work has been cited in numerous print media, television appearances and in a 2005 speech by former Federal Reserve Chairman **Alan Greenspan**. Toby earned a BS in industrial management/industrial engineering with honors and an MS in finance from Purdue University, as well as a PhD in finance from the University of California at Los Angeles.