Why Value Investing Works Best

Steve's blog post yesterday, Bubbles or Just Expensive Assets, discusses an interview with momentum investor Cliff Asness.

The interview was an eye-opener for me. I latched on to value-investing relatively quickly and never ventured into much else. As soon as I grasped that markets were competitive and forward-looking, any strategy involving short-term price movements looked like a waste of time, and certainly not something that *everyone* could profit doing. After all, there are no group profits in short-term trading. One investor's profits must be made at the expense of other investors.

Asness, the momentum investor, has a strategy that buys shares that have gone up over a certain period in the expectation they will rise further. That sounds like a terrible idea to me. Watching the video, though, it's immediately clear that Asness is not a complete buffoon. He knew what he was doing *shouldn't* work if markets function efficiently, and had gone to some lengths to try and ensure he wasn't deluding himself with the data (by mining data until an anomaly was found, for example).

He also had a keen understanding of behavioural biases and was constantly trying to understand why the apparent profit hadn't yet been arbitraged away. The profits were slight, he argued, and inconsistent, meaning the strategy might do terribly for periods and put off those looking for reliable profits. All up he was a smart, well-informed guy, with considered opinions. And he has historically made money with this strategy.

But the one thing that still doesn't stack up about that type of investing, so divorced from the fundamentals, is that there is no way to be sure that what *has* worked, *still* works. What signal will you get when competition from other investors closes the apparent momentum arbitrage? Nothing whatsoever! In fact, you could probably invest with that strategy for 30 years before you had enough evidence to be sure it wasn't working. That's a long time to follow a dud strategy.

That's not the case with value investing. Sure, you don't know what stock prices will do next year, but you do know the periods when you are finding lots of cheap ideas and, contrastingly, when ideas are tough and everything looks expensive. You know, based on price and value, when prospects are good for long-term returns and your strategy is likely to be productive.

I don't expect this will occur but if, one day, the stock market becomes totally efficient and cheap stocks disappear, you will know not to waste your time and we'll all have to find another career. At least you won't be trying to do something that stopped working *years* ago.

That's a powerful advantage. And any other style of investing is not going to give it to you.