Gray, Wesley R. & Carlisle, Tobias E. - Quantative Value

John Wiley & Sons, 2013, [Equity Investing] Grade 

In these times of tight budgets, personnel intensive strategies like value investing has had to make way for indexing but also quantative investing. In the introduction to this book Gray and Carlisle give a short but comprehensive description of the field of value investing, including a wonderful true story with Warren Buffett and Ed Thorp playing bridge. The conclusion from the introduction is that successful value investing more than anything relies of the investor having the temperament to follow through and not succumb to psychological pitfalls. The meeting of Buffett and Thorp thus is an introduction to the theme of the book – value investing merging with quantative investing. This fusion is further explored when in the next section Joel Greenblatt's Magic Formula is described. The task that the authors give themselves is to come up with a quantative value strategy that improves on the successful recipe of Greenblatt.

In order to accomplish this tall order they aim to: 1) find effective accounting red flags to weed out stocks that will cause permanent loss of capital due to fraud and bankruptcies, 2) screen away low quality stocks, 3) find cheep stocks and 4) screen for triggers that hopefully shorten the time between the value investor's purchase of a stock and when the market realizes the full value of it. Finding fraud and triggers add value but the core of the strategy is the other two factors. Basically the authors, just like Greenblatt, seek good and cheap, rather than bad and expensive.

After testing a number of valuation multiples and combinations of multiples, Gray and Carlisle are actually forced to give up. The most effective multiple in the US market between 1964 and 2011 was EV/EBIT, i.e. the same multiple that Greenblatt used. It produced the highest return and Sharpe ratio - substantially outperforming the market. Furthermore stocks cheap on EV/EBIT had the smallest drawdowns. The opportunities for improvement turns out to be larger when it comes to Greenblatt's quality measure ROC. Almost all single year return on capital measures performed pretty much in line with the market or slightly lower. The problem is that profit margins are mean reverting and by targeting the highest return a screen often finds cyclical highs. The highest quality stocks are a type of glamour stocks. The problem is then mitigated in several ways; firstly the authors screen for value first and then seek high quality within the cheap stocks (instead of using a parallel process), then the time span is expanded to averages over 8 years to find persistence, further the definition of quality is enlarged from return on capital to margins and financial strength and finally the authors not only look to the level of returns, margins etc. but also to the trend and the stability. This vastly improves the performance. The back tested Quality Value strategy had a return of 17,7 percent between 1974 and 2011 where Greenblatt's Magic Formula portfolio returned 13,9 percent and S&P 500 10,4 percent. The Sharpe ratios were 0,79, 0,55 and 0.37. Both Quality Value and the Magic Formula had smaller drawdowns then S&P 500.

This is a quality book. It's not hugely original but it's full of common sense in the execution and I'm sure to come back to it. My only fear is that the presented model is too complex, especially compared to the Magic Formula that was exceedingly simple. Complex models that back test well always run the risk of being over-engineered and disappoint further on. Thankfully the logic behind the chosen process is clear and this alleviates much of my worries. Complexity complicates matters but it also lessens the risk of ending up in the most populated corners of the market. As screening can be performed by so many there is an obvious risk of crowding. Algorithms might not succumb to psychological pitfalls, but if manual analysis is framed to avoid behavioural traps I'm convinced it can add rather than deduct value. Fundamental analysis is not yet superfluous.

Mats Larsson, November 18, 2013