Ben Carlson on Active Investing, Value Investing, and Garage Sales

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Wesley R. Gray, Ph.D. 7/9/2015

Yesterday we posted a review on Ben's new book, A Wealth of Common Sense. We reached out to Ben and conducted a follow up Q&A.

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Ben, in your book, you talk a lot about simplicity and minimizing fees and taxes. In many ways, this credo is the credo of passive index investors. Do you see a role for active management? Or is it a waste of time?

I've said in the past that the lines between active and passive management are becoming blurred. I don't think investors need to take an extreme stance and say they'll only invest in index funds or only active funds. I think the comparisons need to rely on the following factors, which I laid out in the book:

- High cost vs. low cost
- Disciplined process vs. discretionary process
- Tax efficient vs. tax inefficient
- High turnover vs. low turnover

I'm more interested in figuring out which risks to take and then finding the best fund option possible based on this criteria.

Interesting. You mention value investing as a potential avenue for active management, but you caveat this claim by saying, "Most portfolio managers don't have the requisite patience to think and act for the long term or their investors don't." Can you elaborate?

As with all strategies, value doesn't work all the time. The current environment is a good example of this. Every time an investment strategy doesn't work for an extended period of time, the weak hands give up on it. It's only the strong hands who are patient enough to see this type of strategy through that end up earning the long-term rewards.

Digging a big more into value investing. On page 136, you mention this wonderful example of how researchers get a bunch of yard sale junk, wrap a good story around the junky items, and then sell them on EBAY for a massive profit. Can you explain how this relates to value stocks and why they may be mispriced?

Humans are hard wired to be impressed and persuaded by an interesting story or narrative. I just read this week that emotionally-driven advertising campaigns work better than rational, data-driven ads by a factor of 2 to 1, and that number seems low to me. One of the reasons value stocks fall out of favor it that glamour stocks usually have a much more appealing story. Glamour stocks are fast growing, exciting businesses, often with a well-known CEO. Value stocks are usually boring and much harder to use in an interesting narrative. For this reason, growth stocks tend to get more attention in the media and from individual investors. The EBAY study I referenced in the book showed that people were willing to pay $50-$75 for every day household items, such as an oven mitt or a shot glass, simply because they had a really great story attached to the sales pitch. This is often what happens with growth stocks.

Okay, so you lay out a clear rational for why value investing will likely work over the long-haul. But you also highlight that it won't be an easy ride, in other words, be prepared for some relative underperformance and the associated career risk fallout. But how would you recommend we go about it? Dig in the financials? Follow Buffett's 13-f filings? Follow an algorithm?

The Warren Buffett route is the one that sounds the best to most people, but it's obviously the most difficult, because very few investors have the ability to run a concentrated portfolio by choosing high quality companies to hold for decades on end, as Buffett has done over time. Most investors don't have the knowhow or the time to spend their days reading quarterly reports or digging through financial statements. I'm a big believer in finding systematic, rules-based strategies that you can understand, so as to not give up on them when they do experience a relatively poor period or performance.

How do you think about various value-investing criteria? How should we weigh the different characteristics (e.g., cheapness, quality, momentum, beta, etc.)?

In the book I say that you should only invest in active factor tilts is you are prepared to do worse for the possibility of doing better. Some investors can handle tracking error, while others can't take it. My favorite aspect of risk factor investing is that you can create diversified streams of returns in your portfolio and take advantage of periodic bouts of volatility by rebalancing and pairing the different strategies together. The allocations to each probably matter less than an individual's ability to stick with them over the various parts of the market's cycles.

Do you think there are other strategies that work as well–or better–than value investing? What are they and how much would you allocate to these strategies?

I just covered the momentum factor on my blog this week and it's impossible to deny the historical performance of momentum. Momentum has been shown to work well with value historically, but there aren't too many momentum-based products out there currently that can avoid the high costs associated with implementing the strategy. I'm a believer in diversifying globally, by asset class, market capitalization and strategy. I view diversification as a willingness to admit that you have no idea what's going to happen in the future. How you allocate your assets depends on your personal risk profile, time horizon and understanding of the markets. You need to have a reason for everything you own in your portfolio and you should never invest in something you don't understand.

There's no such thing as a perfect portfolio, strategy or asset allocation, so I'm all about figuring out what works for your personality and sticking with the process you choose.

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Thanks for the great insights, Ben!

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Note: This site provides no information on our value investing ETFs or our momentum investing ETFs. Please refer to this site.

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