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FORTUNE

# YES, YOU CAN BEAT THE MARKET

by Terence P. Pare´

# YES, YOU CAN BEAT THE MARKET


ALEN MACWEENEY

With value stocks—and some discipline—it *is* possible to outrun the crowd, just like these pros. ■ *by Terence P. Paré*

LIKE THE SHADOWS darkening the twisted canyons of Wall Street itself, one hard truth has hung over investors for more than a generation: You cannot beat the stock market. No matter how smart you are or how hard you try or how well you do in the short run, inevitably the market will pound your investment returns down to the average—and probably worse—before you get to the finish line.

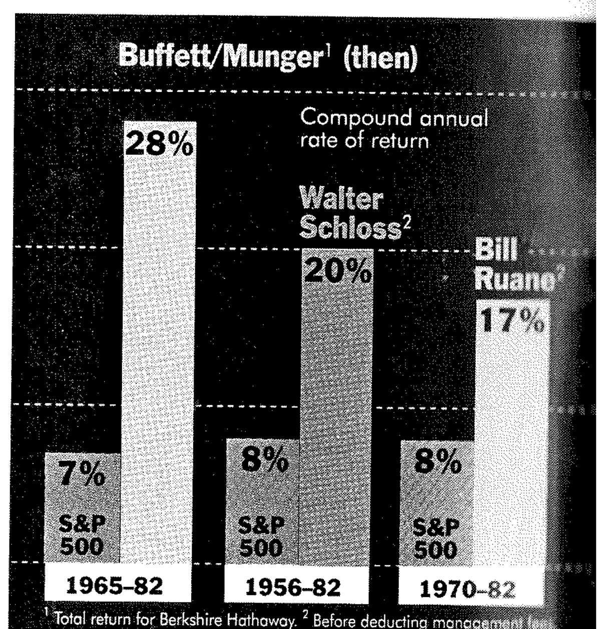
Don't believe it. As it turns out, that bedrock principle of investing may be one of the four great lies. No, it isn't easy, but in theory and in practice, the simple, fairly astonishing truth is that you *can* beat the market, just as the four fellows pictured here have done for decades.

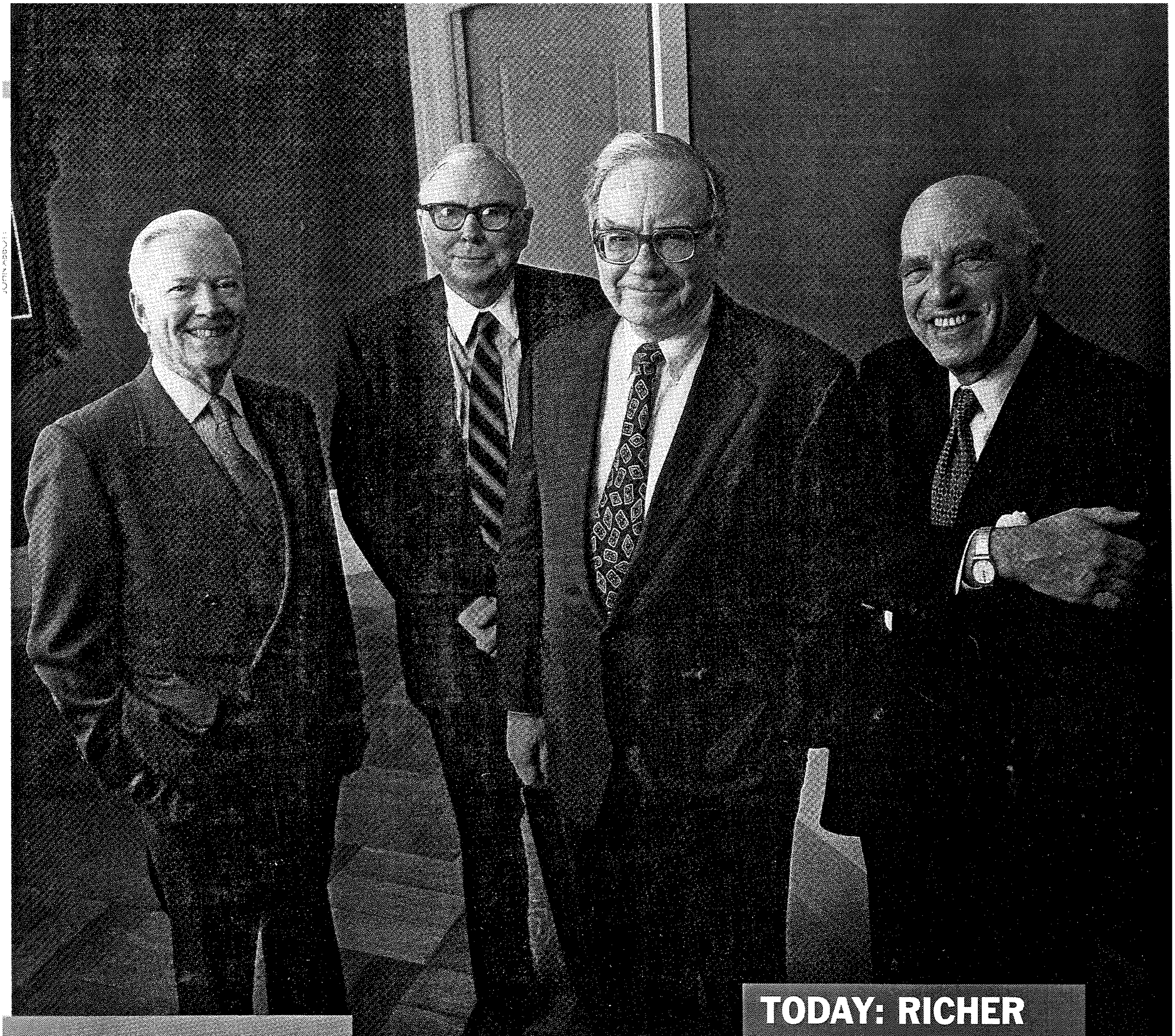
A claim like that goes straight to the infamous efficient-market theory (EMT) like a stake to a vampire's heart. According to this theory, taught as financial gospel in most business schools, the price of a stock always reflects the best estimate of its true value. Since you always get what you pay for and must pay for what you get, you cannot reasonably expect to do better than anyone else in the market when you buy and sell stocks.

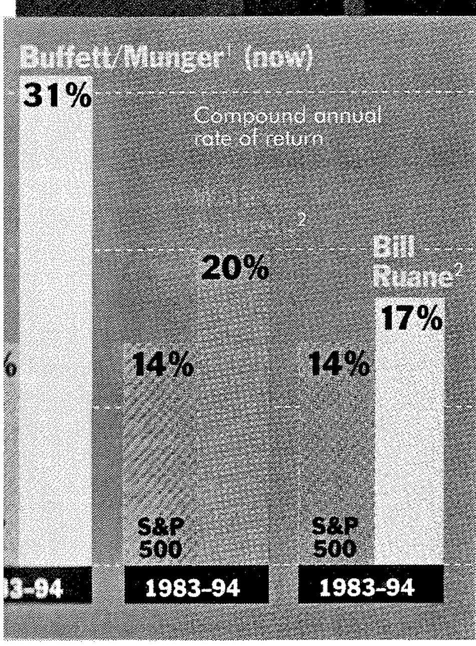
Maybe in theory. But over the years there have been stubborn dissenters from that creed. And now there is groundbreaking academic research showing what some savvy investors have always sensed was true: The prices of stocks are usually wrong. This is no mere eraser fight among a bunch of tweedy academics smoking pipes. When stock prices are wrong, investors able to spot the mistakes can make themselves money—lots of it.

Beating the market has always been tough, but the theory that doing so was impossible didn't really take hold until the mid-1960s, when Gene Fama of the University of Chicago and Paul Samuelson of MIT first began advancing the idea of efficient markets. Aided no doubt by a long period in which equities performed poorly, the EMT fervor spread through universities like Islam under Saladin. By the beginning of the 1980s the efficient-market theory was so widely accepted among academics and so much a pillar of business school curricula that Harvard's Michael Jensen, a staunch proponent of the EMT, worried that even questioning the market's efficiency had become career suicide for his colleagues.

The strongest evidence cited by the EMT believers has always been the lousy returns earned by money managers. Study after study shows that the market regularly beats the pinstriped pants off the vast majority of professional investors, which comes as no surprise to the millions of mutual fund shareholders who saw their fund returns sink below those of the broad market last year. Princeton's Burton Malkiel, author of





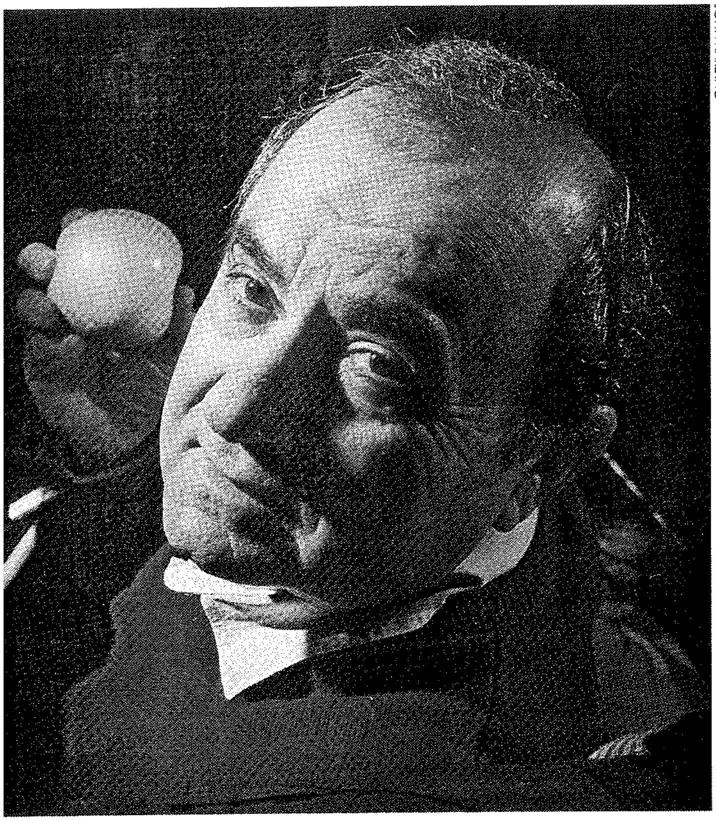




**WHAT DO SEQUOIA FUND'S William Ruane (left), Berkshire Hathaway's Charles Munger and Warren Buffett, and money manager Walter Schloss have in common? They don't believe in efficient markets. Says Buffett: "I'd be a bum on the street with a tin cup if the market were efficient."**

the efficient-market manifesto, *A Random Walk Down Wall Street*, has even more daunting statistics. His studies show that about two-thirds of mutual fund managers and 70% of pension fund managers failed to beat the market over the past two decades. Says he: "If the S&P 500 were an athlete, they'd be testing it for steroids."

Yet for all that circumstantial evidence, the EMT crowd has never been able to explain away winners like Fidelity's Peter Lynch and Windsor fund's John Neff. Lynch has written two best-selling books, the more recent entitled *Beating the Street*, exhorting individual investors to buy stocks. Ask him what he thinks of the EMT, and he answers, "Efficient market? That's a bunch of junk, crazy stuff." John Neff, who is soon to retire from running the Windsor fund, has averaged returns of 13% a year during his 30-year stewardship, compared with the market's return of 11% over the same period.

Or consider the silver foxes in the picture above. In 1983, FORTUNE ran a story featuring these four men—William Ruane, manager of the Sequoia fund, Berkshire Hathaway vice chairman Charles Munger, Warren Buffett, and Walter Schloss, who runs a limited partnership—as affronts to the EMT because their stellar performance records were in open defiance of such theories. Doubters at that time presumably could have dismissed these achievements as the results of mere chance. But 12 years later, these same investors are still beating the market. That's not pot luck; it's proof that something important is going on outside the bounds of the EMT.



JOHN HARDING

**STANFORD UNIVERSITY professor Mordecai Kurz says that mispriced stocks are the rule and not the exception. That may rile academics, but it spells opportunity for investors.**

What makes these successful investors particularly interesting is that their good fortune is not uniformly attributable to extraordinary brilliance—though they are certainly smart—but more to the principles of value investing, which anyone with a solid grasp of high school mathematics can learn. Value investors don't try to predict the growth prospects of the latest high-tech darling. Instead they focus on stocks that are cheap by basic measures such as market value to book value or earnings to price.

Take a closer look at the record of Walter Schloss, a walking, talking refutation of just about every major tenet of the EMT and probably the purest example of a traditional value investor. Schloss, 78, has been beating the S&P 500 since before there was an S&P 500. (Although data for the index now go back to 1926, S&P didn't create the 500 until 1957. Schloss began his market-beating run in 1955, and the following year outpaced what would become the S&P 500.)

Over the 39 years that Schloss has been managing money on his own, the firm has averaged an annual rate of return of slightly over 20%, while his limited partners have made 15.5% a year on their money, reflecting the 25% cut of profits Schloss collects for his services. Over the same period, the S&P 500 averaged a 10% return.

The high returns that Schloss has earned are possible in a world governed by the EMT, but only if you take on much more risk than the market as a whole entails. Schloss, however, has taken less risk. Consider: Since the Brooklyn Dodgers beat the Yankees in the 1955 World Series, the S&P 500 has finished in the red nine times. Schloss lost money in only six years, and eased the pain for his clients in those periods by forgoing management fees. Says he: "I don't think I should get paid if I do a lousy job."

Described by someone who knows him well as "a man of modest talent and light work habits," Schloss practices investing in a way that any ordinary investor can. Dressed in a well-worn trader's smock, he works entirely from public documents and a few publications like *Value Line* in one cramped, little office squirrelly with annual reports, 10-Ks, pictures of Babe Ruth, Lou Gehrig, and Schloss's children and grandchildren. The one window looks out onto an air shaft. The total value of the fixed assets in that office? Three thousand dollars. He has never had a computer or a fax machine, and he still pecks away on an old Olympus manual typewriter to correspond with clients.

Schloss doesn't speak to the managements of the companies he invests in, because he says he doesn't want to get attached to them. And he doesn't attend the companies' annual meetings unless they are within a 20-block radius of his office. The simple truth here is that Schloss holds no advantage over other investors. And he agrees: He claims to have no special ability at analyzing businesses—a modest assertion with which his friends generally agree.

Other investors may fly around the country searching for investment ideas; Schloss is far more likely to spend the entire day chatting with his son Edwin, the only other member of the firm, about the theater or the latest Updike novel, while their one telephone sits, un-ringing, on Schloss's desk. What Schloss does have, however, says Chris Browne, of the old-line investment firm Tweedy Browne, which has provided Schloss with office space for many years, "is the ability to think for himself. Walter leans into the wind until the wind changes."

ALTHOUGH Schloss says that he is flexible, he favors buying cheap companies as measured by market to book value. He prefers looking at asset values rather than earnings because he feels that accounting rules leave too much wiggle room to manipulate profits. Generally he prefers to buy stocks that are selling for one-half to two-thirds of book value. But they aren't easy to find—only about 15 members of the 1,600-stock Value Line universe meet that criteria. So he will go up to 100% of book or even slightly over. He gets in cheap, and when the stock price rises to what he thinks is fair, he gets out. Like many other dyed-in-the-wool value investors, Schloss doesn't put a time limit on stocks he buys. As long as the reasons for buying remain valid, he's willing to wait years for the payoff.

Not all of Schloss's picks work out, but by maintaining a portfolio of about 75 to 100 stocks, which he turns over once every four years, he limits the damage from bad decisions. And he has had a few of those, including Intertan, an electronics retailer that Schloss bought in 1992, when the shares were $12. After Schloss invested, the stock suffered a big drop as its earnings dried up. He sold last year at $8 a share. Says Schloss: "We bought it at about half book value, but it just got worse." Even great value investors occasionally have to admit they were wrong.

Schloss keeps his risk low in other ways: Be-

REPORTER ASSOCIATE *Kimberly Seals McDonald* cause he gets in when prices are already low and the market has low expectations for the company, he runs less chance of disappointment than if he owned fast-growth stocks, where investor expectations run high. Proof of Schloss's low-risk style came in a dramatic way in 1987. Going into that fateful October, Schloss was up 53% for the first nine months, vs. 42% for the market. But he finished the year up 26%, vs. the market's 5%.

There are no secrets to the way that Schloss invests. The value investing he practices can be learned by anyone who takes the time. Just ask Schloss's landlord and fellow outperformer, Tweedy Browne, which has passed on its successful value investing strategy from one generation to the next like Grandma's recipe for *pfefferneusen* (see box).

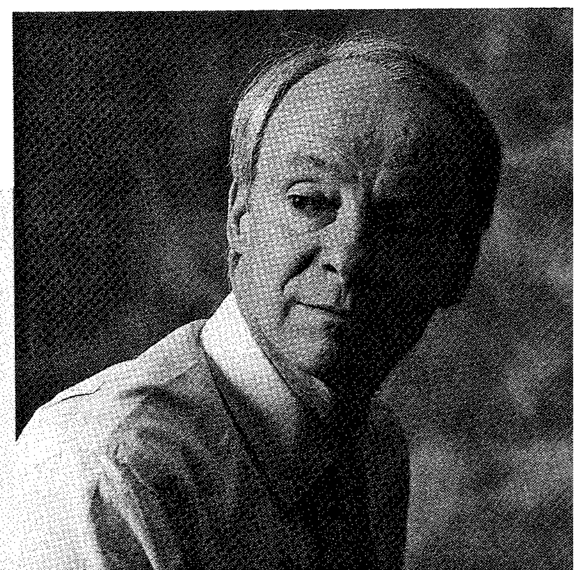
Essential to the success of Schloss, the Brownes, or any value investor is the ability to find undervalued stocks. But for EMT believers, the very suggestion of the existence of incorrectly priced assets is intolerable. The EMT rests on the principle called rational expectations, which assumes that, given the same information, people will react to it, and act upon it, in pretty much the same way. That's because in business we all ultimately seek the same things—wealth and happiness. For stock prices this means that given the same piece of information about a company, investors will generally agree what the correct stock price should be. That is, the stock will be priced at a level that gives it an expected return equal to other stocks. If it were priced to offer a higher expected return, a herd of investors seeking wealth and happiness would immediately jump on that information and drive the stock up, bringing down the expected return.

INVESTORS can beat the market in an EMT world, but the achievement is nothing to brag about. Prices set by rational expectations will change only in response to news, which by definition is unpredictable. So beating the market is possible, but only if this news goes your way. And that can only be a matter of luck that sooner or later must vanish like a gambler's winning streak.

Market efficiency based on rational expectations is all very neat and tidy, but it's also probably wrongheaded. Not only have scores of value investors defied the EMT, but now there is even a countertheory to support the value investor's perspective. Mordecai Kurz, an economist at Stanford University, has proposed a theory that allows for the rational pricing of stocks but also asserts that most of the time those prices are wrong. This is no feeble attack on the efficient-market crowd. Says Nobel laureate economist Kenneth Arrow: "Kurz's work is an important step forward in our understanding of markets."

After pushing a mountain of economic and stock market data through a labyrinth of complex equations, Kurz shows that most of the time equity prices do not correctly reflect all the information about companies. For Kurz, new data aren't unambiguous facts fed into a mechanical market. They are more like concrete clues in an ongoing mystery. As more information appears, the meaning of the clue can change, and investors can adjust their outlook accordingly.

Kurz replaces the idea of rational expectations with that of rational beliefs. This boils down to the idea that investors price stocks not strictly on the basis of new information but also on how well they understand that information. And that depends on how well they comprehend the economic structure of a world that Kurz emphasizes is changing all the time. The difference be-



## WHO SAYS IT CAN'T BE LEARNED?

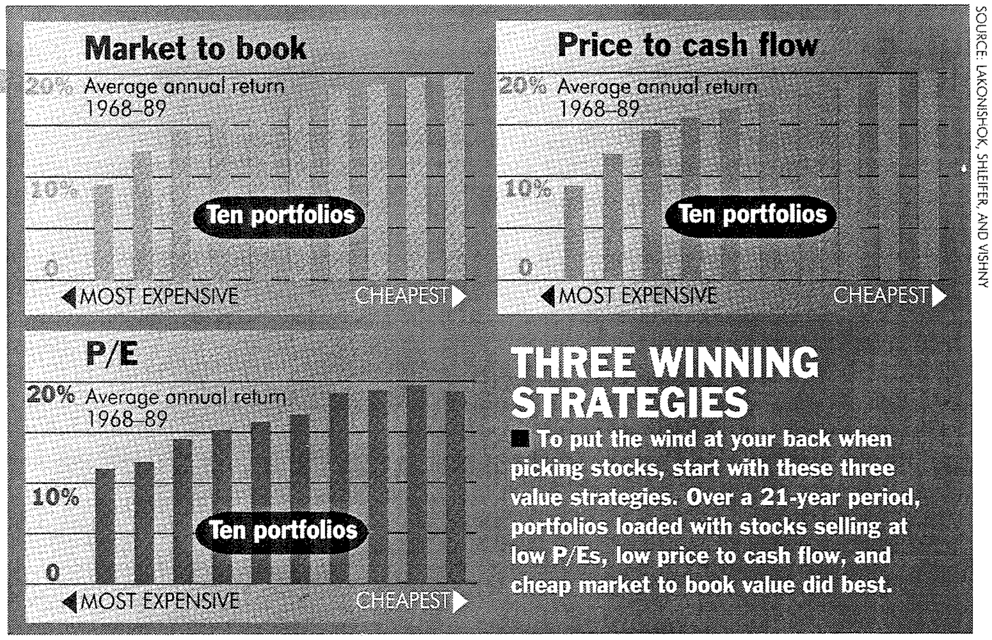
Proponents of the efficient market will accept the possibility of a rare individual who is able to outpace the market because he is so much smarter than other investors. But they would have a hard time explaining the Browne family of Tweedy Browne in New York City, one of the country's most successful money managers. From 1959 through 1994, Howard Browne, succeeded by his two sons, produced an annualized return of 19.5%, nearly double the S&P 500's 10.4% score for the same period. Surely Dad taught the kids something right.

The firm's great run has roots going back to 1943, when Howard Browne and his original partners, Forest Tweedy and Joseph Reilly, set up business to deal in thinly traded stocks. For the new partners, the principles of value investing were unavoidable. Down the hall was their biggest customer, Benjamin Graham, the dean of value investing, who was running an investment fund at the time, Graham-Newman Corp.

After Tweedy retired in 1957, Browne, Reilly, and a new partner, Thomas Knapp, who had worked for Graham, began remaking the brokerage into an investment firm. The company's guiding principle was, and is now, Graham's emphasis on finding companies that are selling for less than their intrinsic value. The firm tweaks the value model slightly, looking for signals of imminent price movements, such as insiders buying their company's stock.

From the time Tweedy Browne began keeping systematic records, it beat the indexes. By 1978, Howard Browne and Reilly had retired, and the second generation of Brownes, Christopher and William, had joined the firm as general partners, along with John Spears and James Clark. The younger Brownes had been coming into the office with their father since they were in high school, so it was a seamless transition. No matter which generation was in charge, Tweedy Browne outstripped the market. So far, five of the firm's ten best years have been under the second generation of management. Including the two mutual funds that the firm recently began offering, **American Value** and **Global Value**, Tweedy Browne now manages about $2 billion.

Then there is Anthony Browne, the other of Howard's sons, and a founding partner of Roxbury Capital Management in Santa Monica, California. He struck out on his own in 1981, and since then has earned an average annual 19% after fees for the accounts




**THREE WINNING STRATEGIES**

■ To put the wind at your back when picking stocks, start with these three value strategies. Over a 21-year period, portfolios loaded with stocks selling at low P/Es, low price to cash flow, and cheap market to book value did best.

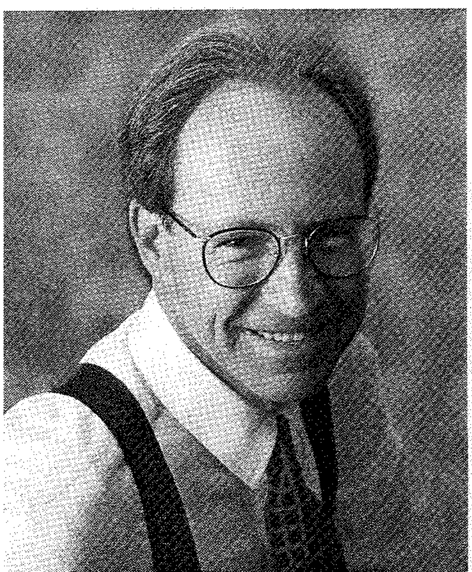
tween the two ideas is subtle but crucial.

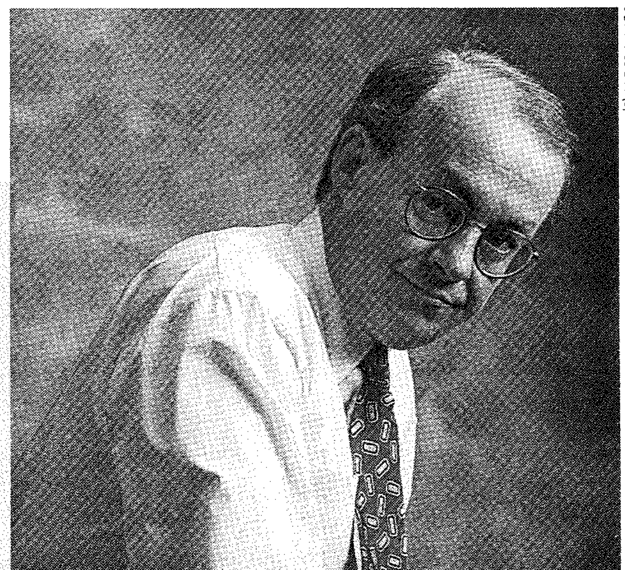
The notion of rational expectations rests on the assumption that investors will price stocks correctly because the economic structure of the world is unchanging, and everyone knows it. Rational expectations will then be uniform, and people will generally agree on the right stock price for a company. Rational beliefs, on the other hand, can differ as long they do not contradict the information. As in the Kurosawa movie *Rashomon*, different people can witness the same event—in other words, receive the same information—and process it in different ways. But, says Kurz, "there is only one truth, and many opinions. Therefore, most people are wrong most of the time."

As investors develop a better understanding of the changes taking place in the world and what they mean, the buyers and sellers of stock will change their beliefs even without new information. So stock prices can change without any news at all as they eventually move closer to their intrinsic value. Kurz calculates that news accounts for only about one-third of the movement of stock prices from 1947 to 1992. The rest of the market's volatility represents what Kurz calls "endogenous uncertainty." Think of this simply as the perplexity of the detective, who changes his mind as he develops a deepening understanding of social and economic clues. One important upshot of Kurz's work, points out Woody Brock of Strategic Economic Decisions in Menlo Park, California, "is that the market will systematically overvalue and undervalue assets."

No doubt the chalk will be flying for years as academics debate the theoretical validity of Kurz's assertions, but investors need not wait for the final grade. Already there is a rising tide of empirical data that demonstrate how frequently the market misprices stocks, and where opportunity lies for every investor.

One potential trove can be found in earnings surprises. The EMT says the market immediately reprices stocks to reflect news, practically as soon as it comes across the wire. But research by Victor Bernard and Jeffrey Abarbanell at the University of Michigan, and Jacob Thomas at Columbia, shows that 25% to 30% of the effect of a surprise earnings announcement on a stock's price comes well after the actual release of the information. Sometimes, says Bernard, it can take as long as six months for the full effect of the new information to be reflected in the prices. Reason? Says Bernard, who began his research as a firm believer in efficient markets and finished it an apostate: "Analysts just don't trust that first earnings surprise. They want to be convinced. So they wait." That doesn't mean you have to. Companies that have recently surprised analysts with exceptionally strong earnings include tool and instrument maker **Danaher Corp.** and **Cabot Corp.**, the world's largest producer of carbon black.





JOHN ABBOTT (3)

**Father Howard Browne learned stock picking from Ben Graham, then passed those tips on to his boys, from left, Will, Tony, and Chris.**

he manages. Says Tony: "I went to Harvard business school and took economics courses at NYU alongside Alan Greenspan, but most of what I learned about the market I picked up sitting around the trading table at Tweedy Browne when I was young."

Thinking back on their dad, who died in 1994 at the age of 89, the Browne boys recall a frugal, laconic man whose outlook on investing, like Graham's, was shaped in fundamental ways by the Great Depression. Despite making millions for himself investing, Browne never lost his eye for a bargain, a dollar of assets selling for 50 cents. Right up to the end of his life, wealthy as he was, he bought clothes at a local thrift shop. Says son Will: "He taught mainly by example."

Dad's Depression-born tightfistedness is reflected in Tweedy Browne's lean operations. The firm has no marketing department and no portfolio managers. The four general partners and five analysts make all the investment decisions. Says Tony Browne: "Value investors don't like to spend a lot of money. It undercuts the effects of compounding too much." That goes for business expenses and for stocks.

Other opportunities are pointed up by studies showing that the market does a far from efficient job simply analyzing basic financial data. Robert Holthausen and David Larcker at the University of Pennsylvania looked at simple financial ratios such as changes in profit margins and inventory turns. Common sense tells you that if a company is turning over its inventory faster and expanding its profit margins, that is a good sign for future earnings. But the market apparently doesn't catch on very quickly. Another study soon to be published by Baruch Lev at Berkeley and Theodore Sougiannis at the University of Illinois found that the market also underreacts to the impact of R&D spending on future earnings.

Investors will appreciate most a study by Josef Lakonishok of the University of Illinois, Andrei Shleifer of Harvard, and Robert Vishny of the University of Chicago, presented at the Cambridge Center for Behavioral Studies last October. The scholars showed that stock-picking strategies using simple measures of value outperform both a strategy emphasizing growth stocks and the market as a whole.

Lakonishok's team classified stocks by four measures: the ratios of market value to book value, price to cash flow, price to earnings, and growth rate for sales. Equities on the lower end of the ladder by these measures were labeled value stocks. Those on the higher end were classified glamour or growth stocks. By each of these measures value stocks significantly outperformed growth stocks. Not only do value strategies outperform growth, but they beat glamour in down markets, and during three of the four recessions that occurred during the sample period.

FROM 1968 through 1990, the S&P 500 was logging an average annual total return of about 10%. But the most value-oriented portfolios in Lakonishok's study—for example, those with the lowest price to cash flow—earned average annual returns of around 20%. And what did the high-growth stock portfolios do? About half as well. Says Lakonishok: "For stocks, as for Hollywood starlets, the future is far less glamorous than the past."

The news from the halls of academe will likely drive successful value investors, who have always bought and sold according to these principles, to the back of the room for a nap. Walter Schloss has always looked at market to book. So has the Sequoia fund's William Ruane; he also pays a lot of attention to free cash flow in relation to price and a high return on equity. This leads him to stable businesses with little need for capital investment like **Capital Cities/ABC**, brewmaster **Guinness,** and retailer **Toys "R" Us**.

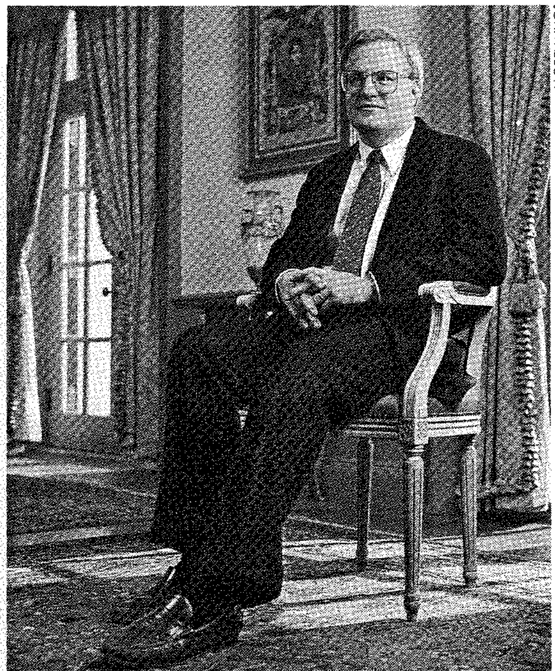
Buffett is a master of exploiting the overreactions of the market. At those times, finding a good value is easy. Or as Buffett puts it: "I'm like a basketball coach. I go out on the street and look for 7-footers. If some guy comes up to me and says, 'I'm five-six, but you ought to me see me handle the ball,' I'm not interested."

One such Hakeem the Dream was **Wells Fargo**, which Buffett purchased during the panic in banking stocks in 1990. True, real estate in California, where Wells operates and where the bank had a large proportion of its loans, was in the dumpster, but Wells

## FINDING THE NEW BUFFETTS

Value investors like Warren Buffett or Bill Ruane, with very long records of superior performance, are of necessity a certain age, but another generation is already picking up where its elders have yet to leave off. Some serve only wealthy clients, while others run mutual funds that can be joined for as little as $500.

Since 1984, Thomas Russo, 39, of Gardner Investments in Lancaster, Pennsylvania, has generated a compound annual return for investors in his Semper Vic Partners limited partnership of 21%. Russo, who runs about $100 million, readily credits much of his success to the training he received at Ruane Cunniff, the firm that manages the Sequoia fund. Like his old boss, Bill Ruane, Russo likes companies with strong cash flows and sturdy franchises. He holds only about 40 stocks in his portfolio, and he will happily hold them forever. Among his current favorites are **Philip Morris** and **Heineken Holdings**, both selling at below-market P/E multiples. Russo accepts new accounts, but only those of $500,000 or more.


JOHN ABBOTT

**Corporate bankruptcies don't scare money manager John Constable. They turn into some of his best performers.**

Training at Ruane Cunniff with Russo was John Constable, 39, of Constable Partners in Radnor, Pennsylvania. He manages about $55 million for his wealthy clients. Since striking out on his own in 1988, Constable has averaged an annual return of 14%, one jump ahead of the S&P's 13% over that period. What he recalls most vividly about his time at the Sequoia fund was the emphasis on rigorous fundamental analysis of income statements. To understand the economics of the tobacco business, Constable recalls, Ruane Cunniff had him figure out what each part of a cigarette cost to produce, so if paper prices started to rise, he could quickly estimate the effect that might have on a manufacturer's profits. Constable only accepts accounts of at least $400,000.

Seth Klarman of Baupost Group in Boston adheres closely to the value investor's first rule of business: Don't lose money. Since opening shop in 1982, when he was 24, he hasn't had a losing year. Over that period, assets in the three limited partnerships he runs have grown to $500 million, thanks in part to annual compound returns of 19%, 20%, and 24%. Eclectic in his approach, Klarman, now all of 37, will buy value wherever he finds it: spinoffs, liquidations, and complex legal situations. What he's least interested in is new money: Klarman is refusing new accounts for the moment, though when he reopens, his minimum is expected to be half a million dollars.

For investors of more modest means, there are some genuine value investors at the helm of a few big mutual funds. In addition to those run by Tweedy Browne, fund analysts point to the **Century Shares** fund, run by Allan Fulkerson, and the **Lindner** fund, managed by Robert Lange and Eric Ryback, as two of the best value funds around.

Fargo's management has long enjoyed an excellent reputation. More important, the company's P/E ratio was lower than it had been for years. It was earning about $1 billion pretax at the time after deducting $300 million for loan losses but was selling for just three times pretax earnings. That spelled value. Buffett paid $289 million for 10% of the bank. At the end of 1994, the five million shares he bought in 1990 were worth $725 million, a 150% gain.

Lately, Buffett's company, Berkshire Hathaway, has been loading up on shares of **American Express**. Amex's credit card business is improving, and the company is buying back stock. In February, Berkshire filed a request with regulators to increase its stake in Amex, already 9.8%, to more than 10% of the outstanding shares. Berkshire also revealed in February that it had purchased 8.3% of the outstanding stock of **PNC Bank Corp.** At $25 per share, the bank's stock price is well below its 1993 high of $36. PNC is also doing a share buyback.

OKAY, so if it's possible to beat the market, and if the techniques for doing so are well known, why in blazes don't more investors, at least more professional investors, do it? In retrospect, all but the brain dead should have been buying, say, Wells Fargo at a P/E of 3. Is there some sort of inefficiency in the intellectual capital market?

No. The problem is more human. A soon-to-be released study by Lakonishok, Shleifer, and Vishny looked at the investing styles of 1,300 pension funds and measured them according to the various rules of value. While many of these fund managers claimed to be value oriented, it turns out that they aren't. Measured by financial ratios, the overwhelming majority of portfolios were not very different from the broad market index. So-called value investors had only slight tilts in that direction. Loaded up on the wrong stocks and facing transaction costs, it's easy to see how difficult it is for the pros to beat the market. Value investors are contrarians, observes Lakonishok. The rest may understand the advantages of value, but when it comes to putting their money on stocks that no one loves, says he, "they just don't stick to their guns."

So while it seems pretty conclusive that there is nothing in the structure of the stock market that prevents you from rising above the average—you can beat the market—other old truths still obtain. Character is still destiny, as the ancient Greeks observed, in life as well as in finance. F