In Defense of Fundamental Analysis: Securities Arbitrage and the Efficient Market Theory

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Frank Shostak (1997) raises valid points in defending fundamental analysis against the efficient market theory (EMT), which holds that the market price of securities always fully reflects available information. According to EMT, it is difficult, if not impossible to outperform the market by consistently picking "undervalued" securities using fundamental analysis. Citing the work of the late Austrian economist Ludwig von Mises (1881–1973), Shostak debunks the EMT framework which views the act of investing in securities as no different from casino gambling (Mises 1963, pp. 809–10).

Securities arbitrage provides another challenge to the EMHT framework, and is fully compatible with the Austrian School of economics. Arbitrage involves the simultaneous purchase and sale of the same securities in different markets to take advantage of price discrepancies that exist. Arbitrage opportunities arise from corporate mergers, hostile takeovers and reorganizations. In a typical example, a merger, the arbitrageur purchases the security of the firm being bought and simultaneously "goes short" (sells) the security of the acquiring firm upon announcement of the deal. An investment opportunity emerges for the arbitrageur in the price spread that develops between the market price for the security of the firm being purchased and the actual buyout or takeover price. The risk for the arbitrageur is that the deal falls apart prior to its closing.[1]

Until the late 1970s, arbitrage was generally unknown outside Wall Street. One reason is its image as a highly intricate, even mysterious art well beyond the understanding of ordinary investors. The shroud of mystery was finally ripped away when arbitrageurs' often pivotal role in the rising volume of corporate takeover deals became increasingly visible (Welles 1981). The image of the prototypical arbitrageur was Ivan Boesky, later convicted of insider trading. But far more

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[1]The classic treatise on arbitrage is Weinstein (1931).

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important to a critique of EMT is the continuous 73-year-old arbitrage record of Graham–Newman Corporation, Buffett Partnership, and Berkshire–Hathaway, Inc., investment entities operated by practitioners of the fundamental analysis dismissed by EMT's academic adherents.

One of Graham–Newman's principals, the late Benjamin Graham (Graham and Dodd 1934), is the father of fundamental analysis. [2] The firm operated from 1926 to 1956. Billionaire investor Warren Buffett headed the Buffett Partnership (1956–1969) and has operated Berkshire–Hathaway, Inc., with his partner, Charles Munger, since the mid1960s. In this 1988 letter to Berkshire shareholders, Buffett notes EMT "became highly fashionable—indeed, almost holy scripture—in academic circles during the 1970s. . . . As corollary, the professors who taught EMT said that someone throwing darts at the stock tables could select a stock portfolio having prospects just as good as one selected by the brightest, most hard-working security analyst." Buffett notes EMT was

> embraced not only by academics, but by many investment professionals and corporate managers as well. Observing correctly that the market was *frequently* efficient, they went on to conclude incorrectly that it was *always* efficient. The difference between these propositions is night and day. (Buffett 1988, p. 37)

While employed at Graham–Newman, Buffett made a study of its earnings from arbitrage during the entire 1926–1956 lifespan of the company. "Unleveraged returns," Buffett writes, "averaged 20 percent per year. Starting in 1956, I applied Ben Graham's arbitrage principles, first at Buffett Partnership and then Berkshire. Though I've not made an exact calculation, I have done enough work to know that the 1956–1988 returns averaged well over 20 percent." During the same time period, he notes, "the general market delivered just under a 10 percent annual return, including dividends. . . . That strikes us as a statistically-significant differential that might, conceivably, arouse one's curiosity."[3]

Berkshire–Hathaway has continued to generate returns greater than the market in the subsequent decade by applying fundamental analysis, including arbitrage. Yet EMT adherents, centered in academia, stubbornly defend the theory and dismiss Buffett's success as an anomaly. Lawrence C. Cunningham, a law professor at Yeshiva University who has edited a compilation of Buffett's essays, observes:

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[2]Graham developed a general formula for analyzing potential arbitrage situations where G is the expected gain in the event of success; L is the expected loss in the event of failure; C is the expected chance of success, expressed as a percentage; Y is the expected time of holding, in years; and P is the current price of the security. The annual potential gain from an arbitrage is shown as follows:

$$\frac{C \times G - L\,(100\% - C)}{Y \times P}$$

[3]In his 1987 letter Buffett (1988, p. 17) writes, "Though we've never made an exact calculation, I believe that overall we have averaged annual pre-tax returns of at least 25 percent from arbitrage."

> Threatened by Buffett's performance, stubborn devotees of modern finance theory resorted to strange explanations for his success. Maybe he is just lucky—the monkey who typed out Hamlet—or maybe he has inside access to information that other investors do not. In dismissing Buffett, modern finance enthusiasts still insist that an investor's best strategy is to diversify based on betas or dart throwing, and constantly reconfigure one's portfolio of investments. (Cunningham 1998, p. 13)

Adherence to EMT forces one to conclude the market cannot be outperformed, and leads one to liken investing in securities to casino gambling. The historical record of investors employing arbitrage to beat the market stands as a powerful confirmation of Mises's rejection of this thesis. The entrepreneur, Mises writes, is not a gambler. Rather, the entrepreneur

> chooses that investment in which he expects to make the highest possible profit. . . . The fact that a capitalist as a rule does not concentrate his investments, both in common stock and in loans, in one enterprise or one branch of business, but prefers to spread out his funds among various classes of investment, does not suggest that he wants to reduce his "gambling risk." He wants to improve his chances of earning profits. (Mises 1963, pp. 809–10)

An entire generation of students has been taught to accept EMT as gospel. They have learned about investing in securities in an academic environment that rejects fundamental analysis. With the Austrian School of economics as his starting point, Frank Shostak has begun the process of reexamining EMT. Applying arbitrage and the historical record of Benjamin Graham and Warren Buffett to EMT would continue this process of critical examination.

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