OPINION

Debunking two popular myths in financial markets

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SPECIAL TO THE GLOBE AND MAIL

PUBLISHED 4 HOURS AGO
UPDATED 51 MINUTES AGO

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From left, the Bank of Montreal, Bank of Nova Scotia, CIBC, and TD Bank at the intersection of King Street West and Bay Street in Toronto's Financial District, on Sept. 24, 2024.

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There are two popular myths in financial markets that I would like to debunk. The first is what is taught in finance programs at academic institutions around the world – namely, that active investors cannot consistently outperform the market because markets are efficient. The second is that lower interest rates should always lead to higher valuations or, conversely, that higher interest rates should always lead to lower valuations.

Let me set the record straight.

Stock picking does add value

Academic studies using aggregated data show that funds that invest in concentrated portfolios and/or deviate significantly from benchmarks tend to outperform. Not every year, but on average in the long run.

For example, in a 2005 Journal of Finance paper, Marcin Kacperczyk, Clemens Sialm and Lu Zheng found that the less diversified a fund was, the better it did. The outperformance resulted from selecting the right sectors or stocks, not from market timing. Moreover, in a 2009 Review of Financial Studies paper, Martijn Cremers and Antti Petajisto show that funds that deviated the most from benchmarks outperformed. And Sohnke Bartram and Mark Grinblatt published a paper in the Journal of Financial Economics in 2018 showing that prices do not reflect the most recent accounting statements, so one can earn risk-adjusted returns that are a result of fundamental analysis and taking advantage of market inefficiencies.

Disaggregated data, too, show that many high-profile value investors have outperformed, on average, the market and/or their benchmarks over the long run. (Disaggregated data involve examining individual investors rather than large data bases that look at investors as a whole.)

For example, data compiled by Scott Reardon of Dakota Value Funds show that more than 50 high-profile value investors have outperformed their benchmarks and/or the markets before and after fees over their lifetimes (or over a time during which they were active money managers), from John Maynard Keynes (over 24 years) to Walter Schloss (over 49 years) and Peter Cundill (over 35 years) to Charlie Munger and Warren Buffett (over 60 years). The key characteristics of all those investors were patience, discipline, integrity and long-term perspective.

You see, value investing is more than investing. It is about lifestyle, and those who follow it tend to live long and outperform those with a short-term mindset. Many notable value investors lived well into their 90s. Some, like Mr. Buffett, are still around. They have a long-term perspective and are patient, not getting their blood pressure up by following day-to-day stock price movements. It is not just luck, as many academics tend to argue, dismissing stock-by-stock analysis as a wasted effort and focusing only on diversification. Investing success comes from stock picking based on bottom-up analysis and careful due diligence.

Interest rates do not always dictate stock prices

Dovish or hawkish pronouncements about interest rates by U.S. Federal Reserve officials often either put a smile on investors' faces or put fear into their hearts. Most market participants believe that falling interest rates are good for the stock market and that rising interest rates are always bad for stock prices.

But that's not always the case. We can have falling stock prices in a declining interest-rate environment, and we can have rising prices in a rising interest-rate environment. It all depends on the reason behind interest-rate changes.

A rise in rates may not necessarily be bad for stock markets providing the rate increases are lower than the increase in the rate of profit growth. Similarly, a fall in rates may not necessarily be good for stock markets if profit growth falls faster than the decline in interest rates.

Investor return expectations are usually tied to the current level of interest rates. As interest rates rise or fall, so do expected returns. This in turn affects the price investors are willing to pay for a dollar of earnings – the so-called price-to-earnings multiple, or P/E ratio. As it changes, so do prices.

However, this argument ignores the growth rate effect of earnings when modelling valuations. In the long run, the true rate to discount future corporate profits is not just the expected rate of return, but rather the expected rate of return less the growth rate in profits.

The key question then is always this: Will corporate profits increase fast enough to compensate for the rise in interest rates? Or, what if corporate profits fall faster than the decline in interest rates? Historically, the rise in interest rates normally coincides with improving economic conditions and a faster growth rate in profitability. The opposite happens in an environment of falling interest rates.

For example, during the first few months of 2024, there were signs of a weakening U.S. economy, leading to a fall in the yield of 10-year Treasuries. Yet, stock-market gains were pretty muted. In more recent months, the yield of 10-year Treasuries has been rising, driven by signs of economic resilience. This has been received positively by market participants, leading to fresh record highs in U.S. benchmarks.

Generalized statements about active managers' underperformance and the effect of interest rates on stock prices mask the true story. The devil is always in the details.

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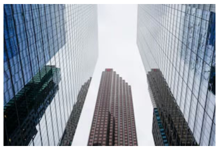

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