



17<sup>th</sup> August 2009

## Hitting it out of the park

“If you can’t beat them, arrange to have them beaten.”

- George Carlin.

What does professional baseball have in common with the stock market ? More than you might think. Research Affiliates’ Rob Arnott, writing in last week’s FTfm supplement, points out the tendency of the stock market to routinely overprice prospects for ‘growth’ stocks at the expense of their ‘value’ peers:

“In the past, did the market overpay for growth and over-punish struggling companies ? Yes. While premium or discount valuation multiples are correlated with future growth or future disappointment, the premium paid for the winners and the discount assigned to the losers is too great.. the market pays an average of about 100% premium for [companies with lofty growth expectations], relative to [companies with poor growth expectations]. The market overpays for future growth – relative to its ability to correctly anticipate that growth – by about two to one.. The market discerns which companies are likely to do best and then overpays for those future prospects..”

As Arnott says, this forms the basis of the so-called value effect, the apparent anomaly whereby the stocks of companies with low price / book and similar ratios tend to outperform the stocks of companies with metrics pointing to high confidence in dramatic future growth. But Arnott also points out the extreme valuations now present in the market. Growth stocks are no longer priced at “just” twice the valuation multiples of value stocks; they are now priced at a 2 ½ times multiple;

“The market has so punished value stocks in the market crash of 2008-09 that, even after a lofty rebound since early March, the spread between growth and value is wider than at any time in past years, with the sole exception of the tech bubble in 2000. Either the market is right or the market is overconfident in its ability to discern future growth opportunities. If the latter, what a time to buy value stocks. And, what a terrible time to bet on growth.”

Of course, it is entirely feasible that the prices of **all** stocks might depreciate over the short to medium term if growth expectations for the broader economy are frustrated. But in a (future) bear market environment, it is at least entirely plausible that ‘value’ will hugely outperform ‘growth’, even if that means incurring a smaller negative return as opposed to a more modest positive one. But it would also seem that, in the absence of conclusive evidence of a sustained

economic recovery, the premium being paid for 'growth' stocks is more than usually unwarranted – by anything other than the madness (or inherent tendency to overconfidence) of crowds.

So where does baseball fit in to this 'growth' versus 'value' debate? In an absolutely fascinating book called 'Moneyball: the art of winning an unfair game' (W. W. Norton, 2004), former Salomon Brothers bond salesman Michael Lewis shows how one of the poorest teams in American baseball, the Oakland A's, under the leadership of its anti-establishment general manager, Billy Beane, and his unorthodox approach to buying talent – at deeply discounted prices – managed sustainably to outperform rivals with far bigger payrolls.

It admittedly took this correspondent years to get round to reading 'Moneyball'. Blame a complete lack of interest in American baseball, for starters. But if you are similarly afflicted and can hop over this minor hurdle, 'Moneyball' repays the effort, in spades. Take Tom Wolfe's verdict, for example:

"What does it take to turn a subject like baseball statistics into a true-life thriller not even a baseball-loathing bibliophile could put down? Answer: saturation reporting, conceptual thinking of a high order, a rich sense of humour, and talent to burn. In short, Michael Lewis. 'Moneyball' is his grandest tour de force yet."

No synopsis of this marvellous book could hope to do it full justice, so of necessity we can only hope to share a tiny distillation of its rich savour here. The essence of 'Moneyball' lies in assessing the state of play of a sporting industry – baseball – and the way it deploys its financial resources, and then scrapping the conventional rulebook entirely. In the view of 'traditional' talent scouts, for example,

"you found a big league ballplayer by driving 60,000 miles, staying in a hundred execrable motels, and eating God knows how many meals at Denny's, all so you could watch 200 high school and college baseball games inside of four months, 199 of which were completely meaningless to you."

Then, fuelled by bloated payrolls and oversized buying power, the bigger name baseball teams would impose a relentless salary inflation upon the sport, taking their pick of the supposed stars but driving up every other team's operating budget in the process. (This sounds unerringly similar to the state of UK professional football, with the key distinction that, Manchester City apart, the most grotesquely moneyed teams are actually winning.)

Not blessed with an overabundance of financial resources, Billy Beane and the Oakland A's are obliged to cut their suit to a different cloth;

"Many of the players drafted or acquired by the Oakland A's had been the victims of an unthinkable prejudice rooted in baseball's traditions. The research and development department in the Oakland front office liberated them from this prejudice, and allowed them to demonstrate their true worth."

While 'Moneyball' centres on the role of Oakland manager Billy Beane, there is an exotic supporting cast of near-grotesques. Like the overweight batter Jeremy "never met a pizza he didn't like" Brown, with a physique not exactly designed to sell jeans, for example; or pitcher 'Country' Chad Bradford, who throws *underarm*. But this is really the point. Appearances can be deceptive. Big name teams routinely overpay for high athleticism or seeming physical perfection; but what really matters, as Beane discovers, is "the ability to control the strike zone" – only to swing at pitches that can be hit well, and to leave all the others well alone. Everything else – "sacrifice

bunts”; “stolen bases”; pitching; fielding; their significance is over-rated (and consequently overpriced) by traditional practitioners of the sport.

### Value stock ?



And the ‘investment philosophy’ adopted by Beane has its origins in work done by Bill James and other “sabermetricians” pursuing the work of SABR, the Society for American Baseball Research, a loose confederation of amateur statisticians tasked with replacing misleading baseball stats with genuinely informative ones. Don’t know your batting average from your on-base percentage ? Michael Lewis / Bill James / Billy Beane and the success of the Oakland A’s will sort you out. No familiarity with the lexicon of baseball is required, because the force and style of Michael Lewis’ writing will sweep you effortlessly along for the ride. It helps, of course, that baseball is one of the most codified and statistically rich sports in the world – English cricket comes close – with metrics rigorously if not obsessively studied by its resident geeks. (In investment markets, they’re termed **quants**.)

So professional baseball, if ‘Moneyball’ is any guide, turns out to have **quite a lot** to do with the stock market. Particularly any stock market where traditional money managers routinely overpay to get growth, when their and their clients’ interests would be altogether better served by a more contrarian approach that focuses on real values and real returns rather than desired ones. In markets as in baseball, you can pay up for what’s popular in competition with everyone else, or you can look for more unconventional beauty at a fundamentally more attractive price, and with a more realistic chance of enjoying exceptional returns.

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17<sup>th</sup> August 2009.

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Ref 1053/09/SB