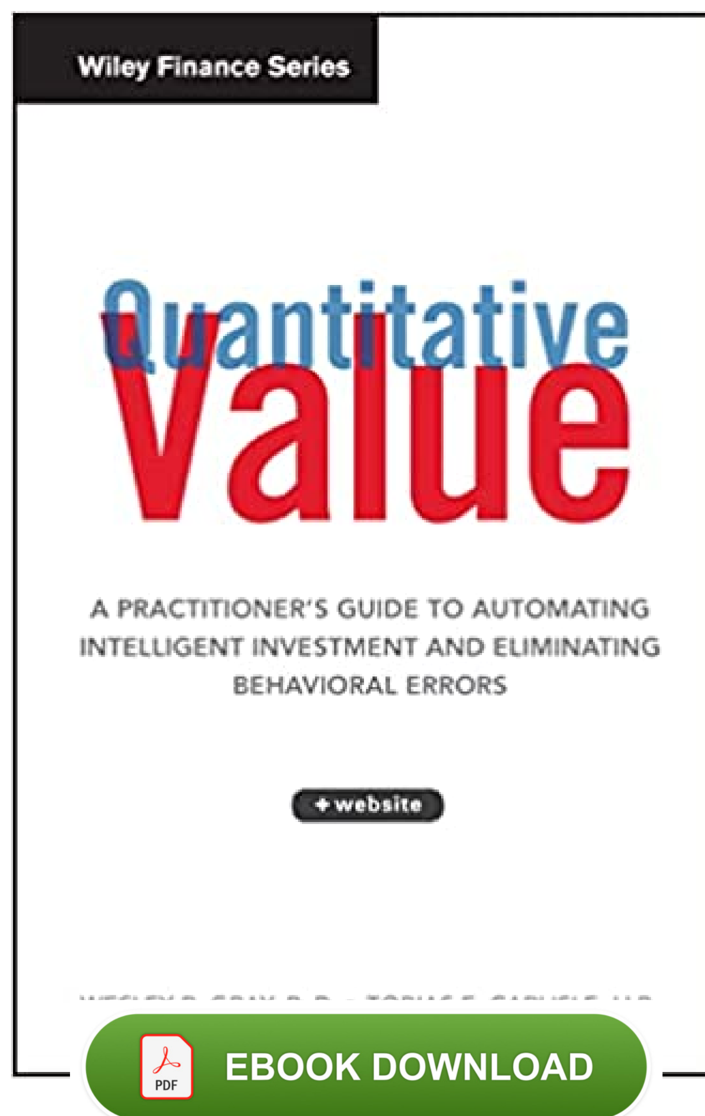
Quantitative Value, + Web Site: A Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors

by

George Sekonda



Synopsis

A must-read book on the quantitative value investment strategyLegendary investment gurus Warren Buffett and Ed Thorp represent different ends of the investing spectrum: one a value investor, the other a quant. While Buffett and Thorp have conflicting philosophical approaches, they agree that the market is beatable. In Quantitative Value, Wesley Gray and Tobias Carlisle take the best aspects from the disciplines of value investing and quantitative investing and apply them to a completely unique and winning approach to stock selection. As the authors explain, the quantitative value strategy offers a superior way to invest: capture the benefits of a value investing philosophy without the behavioral errors associated with "stock picking." To demystify their innovative approach, Gray and Carlisle outline the framework for quantitative value investing, including the four key elements the investment process: 1) How to avoid stocks that can cause a permanent loss of capital: Learn how to uncover financial statement manipulation, fraud, and financial distress. 2) How to find stocks with the highest quality: Learn how to find strong economic franchises, and robust financial strength. Gray and Carlisle look at long term returns on capital and assets, free cash flow, and a variety of metrics related to margins and general financial strength. 3) The secret to finding deeply undervalued stocks: Does the price-to-earnings ratio find undervalued stocks better than free cash flow? Gray and Carlisle examine the historical data on over 50 valuation ratios, including some unusual metrics, rare multi-year averages, and uncommon combinations. 4) The five signals sent by smart money: The book uncovers the signals sent by insiders, short sellers, shareholder activists and institutional investment managers. After detailing the quantitative value investment process, Gray and Carlisle conduct a historical test of the resulting quantitative value model. Their conclusions are surprising and counter-intuitive. The book includes a companion website that offers a monthly-updated screening tool to find stocks using the model outlined in the book, an updated back-testing tool, and a blog about recent developments in quantitative value investing. For any investor who wants to make the most of their time in today's complex marketplace, they should look no further than Quantitative Value.

Sort review

"Quantitative Value is a must read for those with a love of value investing and a desire to make the investment process less ad-hoc. A must read."--Tony Tang, Ph.D., Global Macro Researcher and Portfolio Manager, AQR Capital Management"Gray and Carlisle take you behind the curtains to build a black box based on the best value minds in finance. They combine academia's best ideas with the ideas of Buffet, Graham, and Thorp, to develop a quant system that performs in markets both good and bad."--Mebane Faber, Author of The Ivy Portfolio and Portfolio Manager for Cambria Investment Management"This book is an excellent primer to quantitative investing. It combines insights from both academic luminaries and successful

professional investors, and presents them in a clear, engaging manner. The authors rigorously back-test simple strategies that can be used by the individual as well as institutional investor."--Alex Edmans Ph.D., Finance Professor at The Wharton School, University of Pennsylvania"Quantitative Value is the new guide to Graham-and-Doddsville. Gray and Carlisle synthesize the lessons of the great value investors to systematically identify high quality value stocks while avoiding common behavioral pitfalls."--Tadas Viskanta, Founder and Editor, Abnormal Returns; Author of Abnormal Returns: Winning Strategies from the Frontlines of the Investment Blogosphere."We seek to marry Ed Thorp's quantitative approach to Warren Buffett's value investment philosophy." That's the approach we take in our Value Investing class at UC Davis and Quantitative Value will become required reading for our class. The book we wish we would have written!"--Lonnie J. Rush and Jacob L. Taylor, Managing Partners of Farnam Street Investments and Visiting Professors at UC Davis Graduate School of ManagementFrom the Inside FlapLegendary investment gurus Warren Buffett and Ed Thorp represent different ends of the investing spectrum: one a value investor, the other a quant. While Buffett and Thorp have conflicting philosophical approaches, they agree that the market is beatable. In Quantitative Value, Wesley Gray and Tobias Carlisle take the best aspects from the disciplines of value investing and quantitative investing and apply them to a completely unique and winning approach to stock selection. As the authors explain, the quantitative value strategy offers a superior way to invest: capture the benefits of a value investing philosophy without the behavioral errors associated with "stock picking." To demystify their innovative approach, Gray and Carlisle outline the framework for quantitative value investing, including the four key elements the investment process: 1) How to avoid stocks that can cause a permanent loss of capital: Learn how to uncover financial statement manipulation, fraud, and financial distress. 2) How to find stocks with the highest quality: Learn how to find strong economic franchises, and robust financial strength. Gray and Carlisle look at long term returns on capital and assets, free cash flow, and a variety of metrics related to margins and general financial strength. 3) The secret to finding deeply undervalued stocks: Does the price-to-earnings ratio find undervalued stocks better than free cash flow? Gray and Carlisle examine the historical data on over 50 valuation ratios, including some unusual metrics, rare multi-year averages, and uncommon combinations. 4) The five signals sent by smart money:The book uncovers the signals sent by insiders, short sellers, shareholder activists and institutional investment managers. After detailing the quantitative value investment process, Gray and Carlisle conduct a historical test of the resulting quantitative value model. Their conclusions are surprising and counter-intuitive. The book includes a companion website that offers a monthly-updated screening tool to find stocks using the model outlined in the book, an updated back-testing tool, and a blog about recent developments in quantitative value investing. For any investor who wants to make the most of their time in today's complex marketplace, they should look no further than Quantitative Value.From the Back CoverQuantitative Value offers investors a groundbreaking book and companion website that combines the best aspects of Warren Buffett's value investing

philosophy with Ed Thorp's quantitative approach. By tapping into the strategies outlined in this book and delving into the companion website, savvy investors can harness the power of Gray and Carlisle's winning Quantitative Value approach to stock selection. Gray and Carlisle offer a blueprint for their unique investment strategy and show what it takes to capture the benefits of value investing and leave behavioral errors at the doorstep. The book is filled with solid advice for finding hidden investment gems that outperform over time. Gray and Carlisle also reveal their insiders' secrets for uncovering bargain prices in the marketplace and how to read the signals from smart money investors. Quantitative Value is your key to automating intelligent investment and eliminating behavioral errors. Endorsements "Gray and Carlisle take you behind the curtains to build a black box based on the best value minds in finance. They combine academia's best ideas with the ideas of Buffet, Graham, and Thorp, to develop a quant system that performs in markets both good and bad." --Mebane Faber, Author of The Ivy Portfolio and Portfolio Manager for Cambria Investment Management "An elegant synthesis of Warren Buffett's value investment philosophy and Ed Thorp's quantitative approach. Quantitative Value belongs on every investor's bookshelf."--Charles Mizrahi, Author of Getting Started in Value Investing & Editor of Hiddenvaluesalert.com "Quantitative Value is the new guide to Graham-and-Doddsville. Gray and Carlisle synthesize the lessons of the great value investors to systematically identify high quality value stocks while avoiding common behavioral pitfalls."--Tadas Viskanta, Founder and Editor, Abnormal Returns; Author of Abnormal Returns: Winning Strategies from the Frontlines of the Investment Blogosphere. "Quantitative Value is a must read for those with a love of value investing and a desire to make the investment process less ad-hoc. A must read."--Tony Tang, Ph.D., Global Macro Researcher and Portfolio Manager, AQR Capital Management "We seek to marry Ed Thorp's quantitative approach to Warren Buffett's value investment philosophy." That's the approach we take in our Value Investing class at UC Davis and Quantitative Value will become required reading for our class. The book we wish we would have written!"--Lonnie J. Rush and Jacob L. Taylor, Managing Partners of Farnam Street Investments and Visiting Professors at UC Davis Graduate School of Management "A clear and concise vision of how the two dominant disciplines of modern investing (quant and value) can be combined in actionable ways that produce outsized returns over the market."-Christopher Cole, CFA, Founder and Portfolio Manager, Artemis Capital Management LLC "Gray and Carlisle successfully bridge the gap between fundamental and quantitative value investing--an extremely worthy endeavor and, likewise, an extremely rewarding read."-- MacDuff Kuhnert, CFA, Quantitative Portfolio Manager, Causeway Capital Management LLC "If you liked The Little Book that Beats the Market, you will love Quantitative Value. Gray and Carlisle take systematic value-based investing to the next level."--Raife Giovinazzo, Ph.D., CFA, Research Analyst in Scientific Active Equity, Blackrock "A must read for any investor. The book outlines a broad set of indicators, which can be used to form a quantitative strategy or supplement traditional fundamental analysis. These indicators have been tested by numerous academic studies and represent an invaluable toolset for any investor." --Gil Sadka, Ph.D., Associate Professor of Accounting, Columbia Business

School This book is an excellent primer to quantitative investing. It combines insights from both academic luminaries and successful professional investors, and presents them in a clear, engaging manner. The authors rigorously back-test simple strategies that can be used by the individual as well as institutional investor. --Alex Edmans Ph.D., Associate Professor of Finance, The Wharton School, University of PennsylvaniaAbout the AuthorWESLEY R. GRAY, Ph.D., is the founder and Executive Managing Member of Empiritrage, LLC, an SEC-Registered Investment Advisor, and Turnkey Analyst, LLC, a firm dedicated to educating and sharing quantitative investment techniques to the general public. He is also an Assistant Professor of Finance at Drexel University's LeBow College of Business, where his research focus is on value investing and behavioral finance. Professor Gray teaches graduate-level investment management and a seminar on hedge fund strategies and operations. Dr. Gray's professional and leadership experiences include over 14 years building systematic trading systems and trading special situations, and service as an active-duty U.S. Marine Corps ground intelligence officer (Captain) in Iraq and various posts in Asia. Dr. Gray earned an MBA and a Ph.D. in finance from the University of Chicago Booth School of Business. He graduated magna cum laude with a BS in economics from The Wharton School, University of Pennsylvania.Read more

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The Little Book That Still Beats the Market One Up On Wall Street: How To Use What You Already Know To Make Money In The Market Warren Buffett Accounting Book: Reading Financial Statements for Value Investing Structures: Or Why Things Don't Fall Down Warren Buffett and the Interpretation of Financial Statements: The Search for the Company with a Durable Competitive Advantage Value Investing: From Graham to Buffett and Beyond (Wiley Finance)

What people say about this book

Ebook Library Reader, “Should be read in tandem with "What Works on Wall Street". As far as I know, the only investing books to mesh quantitative investing and value investing have been "What Works on Wall Street," "The Little Book That Still Beats the Market," and "Ben Graham Was A Quant." "Quantitative Value" shares a lot in common with "What Works on Wall Street," and improves on "The Little Book." In fact, this was probably one of the best investing books I've ever read, combining the tried-and-true approach of value investing, behavioral finance, and quantitative methods to produce one very interesting piece. I really, really, REALLY wanted to give this five stars, as it is exceptional, but there were several major issues with their methodology and logic. But first, the positives.PROs:- Explains basic cognitive biases typically affecting investing and how behavioral finance can help improve results by methodically sticking with the Quantitative Value program.- Completely dissects Greenblatt's "Magic Formula" (From "The Little Book That Still Beats the Market"), demonstrating which of the two formulas has contributed more to the returns, how to possibly improve on the formula, and using it as a benchmark to which the authors compare their Quantitative Value approach.- Tests a composite price metric of EBIT/EV, EBITDA/EV, E/P, B/P, Gross Profit/EV, and FCF/EV. Interestingly, the composite score doesn't outperform the best performing single metric (EBIT/EV), which is at odds with the composite score findings in "What Works on Wall Street," which consisted of P/S, P/E, P/B, EBITDA/EV, and P/FCF. Can draw your own conclusions, but I suspect the divergence is due to O'Shaughnessy included P/S and P/FCF, rather than FCF/EV (a flawed metric discussed below) and GP/EV.- Uses Gross Profit to Assets [(Revenue - Cost of Goods Sold)/ Total Assets] and Gross Profit to Enterprise Value, which are both metrics I've never seen tested before in the literature. GPA as a performance metric makes more sense than the traditional Return on Assets (more of this in a bit), and their test results show both produce solid returns.- Compares using 10 year average earnings multiples to the typical last twelve month multiples, which is something I wish had been included in "What Works on Wall Street."- Goes into sufficient detail to detect earnings manipulation (using accruals) and financial strength and distress (Piotroski F-Score, Altman Z-Score, and Beneish M-Score are all discussed). This is particularly useful in deciding which stocks to exclude from a portfolio, as these are the ones most likely to hamper over-all returns.- Keeps the discussion regarding CAPM and Beta to three or so pages. Beta has been discredited enough that it would be nice for it to be never mentioned again in the literature, but the authors limit it to a perfectly acceptable blurb.CONS:- Some of the metrics the authors use to measure "value" and "quality" are not consistent. While Return on Assets (Net income/Total assets) is a popular performance metric, it actually makes very little sense. The numerator, net income, is what's available to common shareholders after interest payments have been made to bondholders. Yet the denominator, assets, is funded with both equity and debt, so comparing it with an income measure that is available only to one class of capital providers just doesn't fit. A better numerator would've been EBIT (earnings before

interest and taxes). I would be willing to overlook this, except the authors make the same mistake with measuring Free Cash Flow (defined as Net Income + Depreciation + Amortization - Changes in Working Capital - Capital expenditures), which is cashflow that is available to equityholders, against both Total Assets and with the Enterprise Value multiple (Market value of debt + Market value of equity - Cash). If the authors wanted to include Free cash flow into the mix, they should've used free cash flow to the firm (cash available to both debt and equity holders, which is Cash From Operations + (Interest expense X (1 - Tax rate)) - CapEx) as measured against Total Assets or Enterprise Value. This is too hard to overlook, as when discussing the Magic Formula, the authors EXPLICITLY explain the logic behind using EBIT to Enterprise Value (as it allows to compare firms with different capital structures equally), but then ignore this when using their own metrics. A terrible gap in consistency.- The authors spend a considerable amount of time talking about Warren Buffett, and even include his quote about how is favorite performance metric is Return on Equity (Net income/Book Value of Equity), which makes much more sense than using Return on Assets. Yet the authors don't even include ROE in ANY of their backtesting at all! How the omitted ROE as a performance metric, but thoroughly backtested ROA and ROC is beyond me.- When discussing the Magic Formula results as according to Greenblatt, the authors mention that they were unable to replicate the results with their own backtesting. Yet Greenblatt stated in his book that the minimum market capitalization he used in his screen was $50 million, while the authors make the minimum market cap $1.4 BILLION. No wonder they weren't able to replicate his results!- In a related matter, the authors also limit their market capitalization to a minimum of $1.4 billion in their own Quantitative Value backtesting. They claim this is done due to the illiquid nature of smaller-sized caps (which is true), thus making their test more applicable to the "real world." While this makes sense for large institutions whose activity can materially affect the market price of a small cap and hamper their ability to buy and sell large blocks of shares, the cut off of $1.4 billion seems rather extreme. Further, for the individual investor, who isn't managing millions and billions of dollars, the illiquid nature of smaller cap stocks shouldn't be much of an issue. This is particularly odd as they even include a quote from Eugene Fama stating that the "Value premium" is most prevalent in small cap securities, as these are ones where mispricing is most likely to be prevalent. On top of this, they include a quote by Buffett, detailing why investing larger sums of money actually hinders performance (and why this is an advantage to the individual investor), yet the authors limit their testing to large caps, assuming individual investors are faced with the same liquidity constraints as institutions. I don't understand the logic behind this small cap exclusion at all, especially when they STATE that small cap value stocks are the ones that beat the market most often.- They use gross profit margin [(Revenue - Cost of Goods Sold)/Revenue] as a signal to whether a firm has "Franchise value" or not. They mention a study by an author who claims that gross profit margin is a better indicator of "true profitability," but provide no evidence beyond quoting that author. As there are other costs associated with running a firm before bond or equityholders receive any cash or earnings (such as sales, general and administrative expenses), I'm skeptical

as to how good of an indicator gross profit margin is. Backtesting Gross profit margin with operating profit margin and net profit margin would've helped their case a lot more.Over all this book is well worth the purchase price. It's a fantastic complement to "What Works on Wall Street," as both provide the individual investor with great insights on how to construct a winning portfolio. The negatives aren't enough to detract from the wealth of evidence they bring to the table on why value investing is the only way to properly invest."

investingbythebooks, "Value quant fusion at its best. In these times of tight budgets, personnel intensive strategies like value investing has had to make way for indexing but also quantative investing. In the introduction to this book Gray and Carlisle give a short but comprehensive description of the field of value investing, including a wonderful true story with Warren Buffett and Ed Thorp playing bridge. The conclusion from the introduction is that successful value investing more than anything relies of the investor having the temperament to follow through and not succumb to psychological pitfalls. The meeting of Buffett and Thorp thus is an introduction to the theme of the book - value investing merging with quantative investing. This fusion is further explored when in the next section Joel Greenblatt's Magic Formula is described. The task that the authors give themselves is to come up with a quantative value strategy that improves on the successful recipe of Greenblatt.In order to accomplish this tall order they aim to: 1) find effective accounting red flags to weed out stocks that will cause permanent loss of capital due to fraud and bankruptcies, 2) screen away low quality stocks, 3) find cheep stocks and 4) screen for triggers that hopefully shorten the time between the value investor's purchase of a stock and when the market realizes the full value of it. Finding fraud and triggers add value but the core of the strategy is the other two factors. Basically the authors, just like Greenblatt, seek good and cheap, rather than bad and expensive.After testing a number of valuation multiples and combinations of multiples, Gray and Carlisle are actually forced to give up. The most effective multiple in the US market between 1964 and 2011 was EV/EBIT, i.e. the same multiple that Greenblatt used. It produced the highest return and Sharpe ratio - substantially outperforming the market. Furthermore stocks cheap on EV/EBIT had the smallest drawdowns. The opportunities for improvement turns out to be larger when it comes to Greenblatt's quality measure ROC. Almost all single year return on capital measures performed pretty much in line with the market or slightly lower. The problem is that profit margins are mean reverting and by targeting the highest return a screen often finds cyclical highs. The highest quality stocks are a type of glamour stocks. The problem is then mitigated in several ways; firstly the authors screen for value first and then seek high quality within the cheap stocks (instead of using a parallel process), then the time span is expanded to averages over 8 years to find persistence, further the definition of quality is enlarged from return on capital to margins and financial strength and finally the authors not only look to the level of returns, margins etc. but also to the trend and the stability. This vastly improves the performance. The back tested Quality Value strategy had a return of 17,7 percent between 1974 and 2011 where Greenblatt's Magic Formula portfolio

returned 13,9 percent and S&P 500 10,4 percent. The Sharpe ratios were 0,79, 0,55 and 0.37. Both Quality Value and the Magic Formula had smaller drawdowns then S&P 500.This is a quality book. It's not hugely original but it's full of common sense in the execution and I'm sure to come back to it. My only fear is that the presented model is too complex, especially compared to the Magic Formula that was exceedingly simple. Complex models that back test well always run the risk of being over-engineered and disappoint further on. Thankfully the logic behind the chosen process is clear and this alleviates much of my worries. Complexity complicates matters but it also lessens the risk of ending up in the most populated corners of the market. As screening can be performed by so many there is an obvious risk of crowding. Algorithms might not succumb to psychological pitfalls, but if manual analysis is framed to avoid behavioural traps I'm convinced it can add rather than deduct value. Fundamental analysis is not yet superfluous.This is a review by investingbythebooks.com"

Brian G, "Comprehensive and a few truisms run to ground. This is a comprehensive walk through a large number of value investing methodologies that have each enjoyed a spell in the sun over the past few years. An understanding of basic finance principles will help the reader but the authors do take the time to explain things as as they go which also helped me because I am more than a bit rusty in some areas. I particularly liked the way they analyze things like Warren Buffet's annual letters to Berkshire Hathaway shareholders and then explain how they relate to some of the models and thinking in the book. All in all, a brilliant read for anyone involved in financial markets, corporate life or personal investing. My only complaint would be that in the kindle edition, the many line graphs use various shades of grey which are difficult to distinguish."

casp, "How to systematically find stocks 'on sale". This is the book that will not only teach you how to buy low and sell high. It will give you the tools to do it as well and this without deep dive inte company reports like Mr. Buffett et.al. For the rest of us things must be simplified and this book does it. The book Quantitative Momentum compliments it well and vice versa."

JOD21V, "A great step forward on the Magic Formula. I found this book very informative and the research well thought out. It is more or less starts as a critique of Joel Greenblatt's Magic Formula, which in itself is interesting. However, it goes much further and attempts, successfully (basktesting), to try an improve on the results produced by the Magic Formula."

GD, "Deep Value Investing with due diligance. This book is good and gives you the system of finding deep value stocks using a checklist designed by the authors. The certain checks are really useful. He has given couple of forensic algorithm to check for accounting frauds. Although not full proof for regular investor without much time these algorithms are great boon. Another good algorithm (read as formula although I am using this word) is F-Score. I have been paying

attention to this score in Indian situation for last few years and I am believer in this rating to avoid permanent loss of capital. perhaps the most useful measure which will influence your returns disproportionately is valuation metric given based on enterprise value. I invest in value stocks and this is my favorite measure for last many years.Overall good system given in this book. You will learn many new things for sure. And it will deepen and broaden your investing learning and horizon.The only catch is this is not easy for small investors to use in totality. you will need access to data, write programs and run those to find the ideas. The entire system is for Quants actually. That is why 4 stars. but you may want to just pick and chose couple of methods that you can easily apply in your investing and you can still get a lot of value out of this book in my opinion. Especially the due diligence methods like pietroski F-score, forensic accounting method etc.I would actually suggest you to read another good book written by one of the authors...Tobias Carlile.. called Deep value. That book is very good for small investors. The method is very simple and is much easy to apply for small investors."

JDR, "Excellent analysis of a large number of successful quantitative strategies. Excellent book. My only minor reservation is that it gets a little repetitive because it reviews a very large number of strategies using the same structure for all the reviews. Some points are made many times. But I still think it is a very valuable book, and it contributed to my knowledge and understanding of quantitative methods."

The book by George Sekonda has a rating of 5 out of 4.4. 140 people have provided feedback.

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