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BOOK REVIEWS

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The Little Book of Value Investing[a]

By Christopher Browne

&

The Little Book of Common Sense Investing[a]

By John Bogle
(*Reviewed by Javier Estrada, IESE Business School, Barcelona, Spain*)

The latest two books in the "Little Book Big Profit" series, Christopher Browne's *The Little Book of Value Investing* and John Bogle's *The Little Book of Common Sense Investing*, share the usual characteristics of this series: They are short, very easy to read, packed with relevant academic results interpreted for the lay reader, sprinkled with interesting stories, and ultimately full of wise investing advice.

The basic investing recommendation from these two little books is the same: Buy a diversified portfolio of stocks and hold it for the long term. An important difference, however, is *what* investors should buy. Browne, a value investor, recommends to invest in "a diversified portfolio of stocks that meets the standards of a margin of safety and are cheap …" Bogle, the founder of Vanguard and champion of index investing, recommends to invest in (surprise!) an index fund that "simply owns Corporate America, buying an interest in each stock in the stock market in proportion to its market capitalization …"

Note that the portfolios recommended by Browne and Bogle are very different. And just as important, note that Browne's portfolio is far more difficult to implement than Bogle's. True, Browne goes out of his way to give investor clues on how to identify value stocks. He goes from basic advice ("Buy stocks like steak … on sale"), to more advanced methods (such as "financial ratios that are good indicators of value" and the appraisal method, which "involves making a company-specific estimate of what the stock would be worth if the company were sold to a knowledgeable buyer in an open auction"), to a comprehensive 16-point checklist.

Browne rightly points out that patience is "the hardest part of using the value approach." But my guess is that most investors would also have trouble following Browne's approach to identify a portfolio of value stocks to buy and patiently hold. Investors wanting to identify value stocks will find the advice of Joel Greenblatt in *The Little Book That*

[a]Wiley, 2007, Hardcover (Little Book Big Profit series)

Beats the Market far easier to implement. Greenblatt reduces the selection of these stocks to just two variables, P/E (go for low) and return on capital (go for high), and even offers an online screen that helps investors find stocks that meet these two criteria.

Alternatively, investors can opt to follow Bogle's straightforward recommendation: Buy a fully diversified index fund and hold it for the long term. This advice will obviously come as no surprise to those investors that stay tuned to the financial press, where Bogle's opinions are often quoted and discussed. And the basic argument supporting Bogle's advice is not new either: Investors (both individual and institutional) are not good at deciding what to buy and sell, or when to buy and sell; hence, they should simply minimize transaction costs by minimizing turnover.

Bogle argues (somewhat tautologically) that, as a group, investors underperform the market. This is because beating the market before transaction costs is a zero-sum game, but beating the market *after* transaction costs is a *loser*'s game. The advice of minimizing transaction costs by minimizing turnover then easily follows ("We investors as a group get precisely what we don't pay for. So if we pay nothing, we get everything").

We have no space here to discuss the many interesting numbers that Bogle uses to support his arguments. He compares the performance of funds to that of investors in funds; the performance of the market to that of mutual funds; performance before and after transaction costs; and performance before and after taxes. And in every case shows (unsurprisingly) that the second is lower than the first, and (perhaps surprisingly) that the magnitude of the difference is very large.

Echoing Churchill on capitalism, Bogle claims that while "an index-driven strategy may not be the best investment strategy ever devised, the number of investment strategies that are worse is infinite." And after defining investment success as "earning our fair share of whatever returns that our business enterprises are generous enough to provide in the years to come," he claims that the "classic index fund is the only investment that guarantees the achievement of that goal." Again, no surprises here.

More surprising is, perhaps, Bogle's negative opinion on exchange traded funds (ETFs). To be sure, his problem is not with broad-market ETFs when they are bought and held for the long term. Rather, his problem is with the possibility that ETFs encourage investors to trade frequently (something that Bogle obviously disapproves of) and with the proliferation of ETFs that intend to track indexes other than the broad market (such as styles, industries, or countries). Bogle's negative view on fundamental indexes (those in which stocks are weighted not by market cap but by price-insensitive measures of value, such as dividends, sales, or book value), however, is less surprising.

Investors that follow Browne's advice would most likely end up with a portfolio that delivers a higher return than those who follow Bogle's advice. This is simply because, as has been thoroughly documented for a wide variety of countries and time periods, in the long term value stocks outperform both growth stocks and the market. But Browne's followers would be exposed to more risk than Bogle's followers on two counts: Value stocks are more volatile than the market; and, importantly, although it is impossible to go wrong when buying the portfolio recommended by Bogle, there are many ways to go wrong when buying stocks following Browne's guidelines.

In short, I have little doubt that individual investors will find these two little books interesting, instructive, and certainly worth reading.