By Aswath Damodaran
John Wiley & Sons, Inc.
504 pages

the reading room
investment philosophies

review rating
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Professor Damodaran teaches at New York University and he enjoys a solid reputation in finance education, including training courses in corporate finance. He has written several books in related areas, eg: on investment management and valuation. The references within this book span 14 pages, clearly indicating a deep knowledge and thorough analysis of the subject matter.

All that recognised, this book is of limited value to the Australian investor, unless you are looking for a potted ABC overview of just about every area of investment that is potentially relevant to the US investor. ABC, because the canvas and field of vision is so wide, that there is a limitation as to how deep the text can go in relation to any given subject matter. Take Chapter 7, "Smoke and Mirrors? Charting and Technical Analysis" – as although the chapter does provide an interesting introduction to the subject, the investor could not possibly use this text as the basis for establishing an investment strategy using charting. Moreover, this chapter is equivocal on the merits of charting, which might encourage an investor to enter this dangerous territory.

This book is rated five, for the reason that the opening words of the final chapter do resonate in the mind of your reviewer: "If the purpose of this book is to provide you with the tools to pick an investment philosophy, you may very well feel that it has failed. After all, there seems to be both good and bad in every philosophy and no one philosophy seems to dominate over time and yield consistent winners. What purpose has been served, you might wonder, from this examination of diverse and contradictory views of how markets work and fail to work?" I regret to report, that this rhetorical question might be answered with an unflattering verdict.

Due to the comprehensive approach the book could be used as a compendium reference work, and perhaps this is the best place for it on the shelf. It is certainly thorough in coverage and has a good index, so that, for example, of you wanted to know about "PEG ratios" you would be drawn to pp 296-301 where there is an excellent discussion of the shortcomings of PEG ratios. However, if you were working through the "Basics of Valuation" at page 99, and first came across the PEG ratio, you would find no reference to that later, more detailed, coverage – for there is little linkage and cross-referencing between the topics spread throughout the book.

There are many major works on investment and finance reviewed in this web site, where their US origin and focus does not materially detract from their utility/value from the Australian perspective. However, there are many areas in this book that should be read with considerable caution by an Australian, due to the differences in our market, tax laws etc. In relation to the generic subjects that travel better across borders, for example, an explanation of the key valuation concepts (eg, standard deviation), my preference would be the work of Mark Kritzman reviewed in this web site.

Coverage includes such diverse areas as: the rationale for establishing an investment philosophy and sticking to its core values; risk evaluation and measurement; accounting issues, analysing earnings/profitability and cash flows (a truly 10% ABC intro.); the basics of valuation; trading execution and taxes (the latter of limited relevance to the Australian investor); the market efficiency debate; charting and technical analysis; value investing under the Graham/Buffett approach; the value/growth and small/large cap performance question (references to Fama and French and use of considerable French sourced data); trading on information and momentum investing; contrarian investing; arbitrage and hedge funds; market timing; the active/passive debate and the merits of indexing – all in 500 pp. The approach seems to ring of extracts from the Professor's lectures/papers, and there are several instances of source data ending in the 1990s, when this should be available in more contemporary form, eg, free from Ken French's web site at Dartmouth.

The discerning reader might come across considerable corroboration of his/her already entrenched views on investment philosophy, particularly in relation to value investing. There is overwhelming evidence of long term out-performance of value investing (eg, sticking to low PEs), but Professor Damodaran seems to wish to qualify and reserve his position – even on this point. He observes that it is "easy to see what Warren Buffett did right over the last half century, but it will be difficult for an investor to replicate that success." – which some might disagree with, at least in relation to Buffett points of principle. One replication a US investor might have applied with some benefit in 1999, is not to have invested in technology stocks if he/she did not understand them!

Other areas of interest to the Australian investor would include: discussion of the mixed performance of hedge funds (convincing references to studies and historical data); the equally poor track record of fund managers who engage in tactical asset allocation and who attempt to time the market (eg, by holding excess cash in equity funds due to their bearish outlook); and in Chapter 13 a very detailed and convincing indictment of active funds management generally, addressing such matters as: fund size, fund age, style (eg, value/growth/socially responsible etc)

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and straying from mandate, etc. There are certainly lessons in this for the Australian investor and it confirms our thinking, in relation to Winston Private's Investment Philosophy in several material respects – eg, the questionable value of fund ranking/ratings by research houses and the doubt over long term continuity/persistence of out-performance both in relation to funds and to individual managers.

Chapter 13 also addresses fund turnover and taxes, and confirms the views of this reviewer on these matters. There is reference to the study of Lakonishok, Shleifer and Vishny who looked at the returns funds would have made (as opposed to actual post trading returns) if they had frozen their portfolios at the beginning of each year. The finding was that trading activity during the year actually detracted from performance, so that "In other words, these funds would have done better if they had sent everyone home at the start of the year and not traded over the course of the year." Close study of this section might save you considerable money in the long term, and would cover the cost of this book. Its compendium value, would then be a nice bonus, to be drawn upon, as exigencies might dictate.

Finally, one style observation. The author uses the royal "we" throughout the text, notwithstanding that the book claims but one author – you will not find a single "I". A new American hierarchical/heraldic tradition?

MARTIN EARP
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