Is Value Investing the Riskiest Investment Strategy?

Description

Value investing has been a hugely popular and successful investment strategy for decades. Proponents of value investing include Benjamin Graham and Warren Buffett – both of whom went on to achieve staggering returns over a prolonged period of time.

While the rewards from value investing appear to be relatively high, the risks may also prove to be greater than many investors realise. Specifically, value investing can leave an investor exposed to value traps, where a stock's price is cheap for very good reason.

Value traps

Value traps are perhaps more common than many investors realise. Even with share prices across the globe having risen since the start of the year, there are still a number of shares which continue to trade at major discounts when compared to the wider index.

While some of them will go on to recover, others will not. However, cheap share prices often attract value investors because it appears as though capital gain prospects are high. Therefore, for many investors, value investing appears to be a high-risk strategy which can lead to significant losses.

More than just price

While value traps are an operational hazard of value investing, the reality is that there is more to 'value' than simply a low share price. As Warren Buffett has stated, 'it is better to buy a great company at a fair price, rather than a fair company at a great price'. In other words, the quality of a business must be considered alongside its valuation.

Even if a company’s shares are trading for a fraction of their net asset value, there may be a significant risk ahead which ultimately prevents them from recovering. Similarly, a stock which has a valuationthat is in line with that of the wider index may in fact offer superb value for money if it is expected torecord a rapid rise in earnings over the medium term. As such, value investing is perhaps at its bestwhen a range of factors, including price, are considered before buying a slice of a business.

Cyclical changes

Of course, as stock markets rise it becomes more difficult to be a value investor. While many investors are buying, value investors tend to be selling up and moving into other assets such as cash. It’s a similar story when markets are at a low ebb, since value investors will go against the general consensus and buy stocks instead of selling them.

Therefore, it can be a challenging existence as a value investor, and in the short run it is all too easy to experience paper losses as past trends continue. However, in the long run it has been proven as a successful technique for investors of a range of abilities and experience levels. Certainly, it is not without risk. But provided an investor focuses on more than just price, it can prove to be a highly profitable strategy in the long run.

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