**Introduction**

In today’s world, there are four main approaches to investing – passive investing, fundamental analysis, technical analysis, and quantitative analysis. These different approaches reflect different philosophies on financial markets, the analysis of data, and the role of information (Grimm 2012). Attempting to reconcile these approaches with economic theory, one sees that only fundamental analysis can fit within the framework of Austrian theory, whereas the other approaches contradict it on numerous points and are thus incompatible with Austrian theory.

**Passive Investing**

 The first approach to investing is what is known as passive investing. This involves holding a diversified portfolio of stocks which proxies the return of the market. An example would be purchasing the S&P 500 index. This approach to investing is based on the efficient market hypothesis, which will constitute the bulk of my analysis here.

The efficient market hypothesis[[1]](#footnote-1) claims that stock prices always reflect all publicly available information on that particular stock and that stock prices adjust virtually instantaneously to new information. The efficient market hypothesis contends that all prices are ‘correct’ as they reflect all the information available at that time. Therefore, trying to select one stock over another, regardless of the selection criteria, would be a waste of time. By implication then, investors cannot beat the stock market and should simply hold a diversified portfolio of stocks to generate the same return as that of the market.

 While prices do undoubtedly adjust to new information, assuming that a stock price is always ‘correct’ is to engage in many theoretical failings. The first problem with the efficient market theory is that it fails to deal with issues related to the unequal access of news. An investor may be willing to trade on a certain piece of news, but only gets the news several days later. Even though the price of the stock is supposed to have perfectly adjusted to this new piece of information by now, this investor may still buy the stock based on this piece of information. The EMH thus excludes time lags from its framework. Similarly, one investor may take longer to deliberate on a certain piece of new information than others. While one may trade right away, another may think about the effects of this new piece of information and do further research before deciding to trade based on that news. A still further problem in regards to new information is the issue of news interpretations. The exact same piece of information may be interpreted bullishly by some market participants and bearishly by other participants (Shostak 1997).

 This leads into the next problem which is that the efficient market hypothesis assumes market participants have the same expectations regarding stocks. But this idea is of course quite problematic. While this is obviously not true empirically, it also causes a theoretical problem. If all market participants had the same expectations on what the price of a stock should be (a consequence of the stock being priced ‘correctly’), then there would be no trade in that stock. The EMH framework is unable to explain why investors trade large amounts of shares on stock exchanges every day in the absence of significant information changes. Since the stock is supposed to be priced correctly, this activity is unjustified according to the efficient market hypothesis (Shostak 1997). Instead of recognizing that investors will make choices based on their subjective interpretations of data, the efficient market hypothesis thus turns investors into robots who will all react to information in the same way (“The Austrian Approach to Investing 2009)”.

 Another issue with the EMH is that it ignores the possibility of unequal knowledge between market participants. Even if one has the same information on a particular stock as another, a greater knowledge of the macroeconomic situation may lead one investor to buy a stock while the other remains on the sideline (Shostak 1997).

 A fifth problem with the efficient market hypothesis is that it ignores the later effects of credit expansion. In the efficient market model, if the Federal Reserve announces an interest rate cut of 1%, this new knowledge will quickly be embedded into stock prices. It ignores however, the after effects of the credit expansion. The boom-bust cycle is totally over-looked in the world of the efficient market hypothesis and simply does not exist. The EMH framework also ignores that certain markets will be disproportionately affected by the Federal Reserve’s credit expansion (Shostak 1997).

 A sixth problem with the EMH framework is that it ignores entrepreneurial activity. Entrepreneurs make their profits by recognizing under-valuations in the market. In the EMH framework, though, there should be no under-valuations, since market prices are priced ‘correctly.’ There is thus no place for the Austrian theory of the entrepreneur in efficient market theory (Shostak 1997).

 A seventh problem encountered by the efficient market hypothesis is that it implies that firms have the ability to immediately assess consumer preferences. For example, a company announces a new product that many believe will be very successful and popular with consumers. The price of the stock immediately adjusts to this new piece of information. However, consumer preferences can only be demonstrated, not assumed. Time will tell whether or not consumers are happy with this product. But in the EMH framework, this successful product will be embedded in the company’s stock price (Shostak 1997).

 Another theoretical failing of the EMH is its assumption that diversification is always better (“The Austrian Approach to Investing” 2009). Since one can’t be the market, he should just hold a diversified portfolio which will replicate the return of the market. Mises (1949) notes that the entrepreneur does indeed diversify his capital in order to achieve greater profits. However, this implies that the reverse may also be true. If an entrepreneur determined that he could make the greatest profits by not diversifying his capital, he would fail to do so.

Another problem with the efficient market hypothesis is that it cannot account for lack of capital to buy a stock. An investor may believe that a stock is under-valued but he does not have sufficient funds to purchase the stock and drive up its price until it is no longer under-valued. Thus, the stock might still be under-valued in the mind of this investor, but there is nothing more that he can do about it. The market is therefore ‘inefficient’ within the framework of efficient market theory (Murphy 2011).

 There is also the issue of low risk tolerance which causes problems for EMH theory. A retiree may well believe that bonds are not a great investment, but he is willing to forego greater returns elsewhere or even take a loss on his portfolio, so long as he preserves a large amount of his capital (Murphy 2011). He thus allocates his funds according to his subjective preferences, not necessarily what will generate the highest returns. Consequently, bonds would be over-valued in this example according to the EMH.

 Finally, the statistical tests themselves which ‘prove’ the efficient market hypothesis are theoretically flawed. These tests rely on the erroneous assumption of a constant probability distribution of stock returns. However, all entrepreneurial ventures are unique and their rates of return thus can’t be standardized, regardless of how this standardization takes place. The industry that the company is competing in may become more competitive over time and thus lower the company’s profit (and hence lower the average increase in its stock price). Worse yet, the profitable opportunity may disappear, for any number of reasons – the company’s special technology may become obsolete, consumer preferences may change, etc. Similarly, past returns cannot be assumed to be homogenous information. A return of 4% in 1998 demonstrates a different set of historical particulars than a 4% return in 1999. As a consequence of the above, there is no quantifiable assumption that can be made about possible stock returns. Assuming that all returns fit under a bell-shaped curve is completely erroneous. Assuming that all stock returns had an equal chance of being generated would also be erroneous. We simply don’t know the outcomes of unique entrepreneurial ventures, in terms of both their profitability and their longevity (Shostak 1997).

**Fundamental Analysis**

Fundamental analysis is an approach to investing developed by Benjamin Graham and David Dodd. It is “a process of gathering and analyzing information specific to determining the prospects of a security’s future performance. It often requires gathering economic, industry, and company-specific data, and then utilizing this information to arrive at an appraisal of present or future price” (Grimm 2002, p. 97). The approach

“requires the estimation of a stock’s intrinsic value based on rigorous analysis of financial statements. A stock whose intrinsic value exceeds its current market price by a wide enough margin is determined to have a ‘margin of safety’ against downside loss. These stocks are ‘undervalued’ and can be considered a suitable choice for investment. If the current market price is selling close to or at a premium to intrinsic value, investment in the stock is disregarded” (Grimm 2012, p. 228-9).

Fundamental analysts may analyze operational efficiency, management quality, product or service characteristics, the firm’s balance sheet, and other factors to come to a conclusion of what a stock’s price should be.

Fundamental analysis may be conducted in a bottom-up manner or it may be conducted in a top-down manner. If a fundamental analyst is using the bottom-up method of analysis, he would analyze the firm as a standalone entity. This would not involve a detailed analysis of industry conditions or of conditions in the broader economy. It would instead focus on the business fundamentals – its product quality, management quality, etc. The top-down approach, to the contrary, would begin with the world economy, then move to the industry conditions, and finally, to the firm itself (Grimm 2012).

While not originating within Austrian theory, fundamental analysis is largely compatible with it. Its chief similarity consists in representing investing as an entrepreneurial discovery process in which capital is allocated to the most worthy firms (Grimm 2002). An extension of this can be found in the lack of credence fundamental analysts give to ‘market consensus’ views. This is compatible with an Austrian theory of the entrepreneur where it is only the entrepreneur who discovers the profitable opportunity. Ludwig von Mises (1949, p. 871) states:

“Entrepreneurial judgment cannot be bought on the market. The entrepreneurial idea that carries on and brings profit is precisely that idea which did not occur to the majority. It is not correct foresight as such that yields profits, but foresight better than that of the rest. The prize goes only to the dissenters, who do not let themselves be misled by the errors accepted by the multitude. What makes profits emerge is the provision for future needs for which others have neglected to make adequate provision.”

 Somewhat similarly, Benjamin Graham, the originator of fundamental analysis has stated: “in our experience and observation, extending over 50 years, we have not known a single person who has consistently or lastingly made money by ‘following the market’. We do not hesitate to declare that this approach is as fallacious as it is popular” (Leithner 2005, p. 10). Graham has moreover made the observation that investment will be its most successful when it is conducted in a business-like manner (Leithner 2005), demonstrating further compatibility between fundamental analysis and Austrian theory.

Like Austrian theory, fundamental analysis represents investment as a process of understanding and interpreting information in the human mind, as opposed to interpreting it through some model divorced from the real world (Grimm 2002). This is easily seen in the distrust which fundamental analysts have of the statistical models commonly used in contemporary finance. For example, Benjamin Graham (Leithner 2005, p. 7) has said:

“in 44 years of Wall Street experience and study I have never seen dependable calculations made about common stock values, or related investment policies, that went beyond simple arithmetic…Whenever calculus is brought in, or higher algebra, you could take it as a warning signal that the operator is trying to substitute theory for experience, and usually also to give speculation the deceptive guise of investment.”

Besides these first few similarities, there are in fact many other compatibilities between Austrian theory and fundamental analysis. For example, price and value are distinct things, as price does not necessarily equal value in the framework of fundamental analysis (Leithner 2005). This corresponds with Austrian theory where an individual will receive more value from a good he bought than the price he paid for it.

Additionally, like Austrian theory, the method of fundamental analysis assumes that the future is uncertain (we cannot know the exact outcomes of certain entrepreneurial ventures), but at the same time, the future is not radically uncertain (meaning completely unpredictable). We are capable of finding the companies that figure to do better than the rest. For example, Austrian investor James Grant (“The Trouble with Prosperity” 1996, n.p.) notes, in regards to investing, that

“Austrian theory has certainly given us an edge. When you have a theory to work from, you avoid the problem that comes with stumbling around in the dark over chairs and nightstands. At least you can begin to visualize in the dark, which is where we all work. The future is always unlit. But with a body of theory, you can anticipate where the structures might lie. It allows you to step out of the way every once in a while.”

And finally, fundamental analysis holds a similar conception of risk compared to Austrian theory. Risk is embedded in the nature of the firm and its business process, whereas modern finance holds a company is risky on account of the volatility of its stock price. Modern finance incorrectly ignores the profitability of the underlying business in assessing risk.

**Technical Analysis**

 Technical analysis is a method of investing that uses charting and statistical techniques to forecast future security prices. Examples of such techniques include the use of 50 and 200 day moving averages for stock prices, support and resistance levels, head and shoulders patterns, Bollinger bands, the relative strength index, moving average convergence/divergence indicators and a whole host of others.

 To give you an idea of the logic of technical analysis and how these approaches work, let’s take a few examples. A 50-day moving average tracks the average of a stock price over the last 50 days. Each day, the newest observation is added and the oldest observation is dropped. When a stock price is falling, the moving average will be above the current price (due to the higher old observations). When the price is rising, the moving average will be below the current price (due to the lower old observations). The crossover point, when the current price breaks above its moving average, is construed as a bullish indicator. This same technique is also popular with 200 day moving averages (Bodie, Kane and Marcus 2010).

 Support and resistance levels are certain price levels on a stock chart that the stock has not broken. For example, a stock price graph across the last 6 months shows that the stock approached $40 three times, but failed to go below $40 all three of those times. There is thus a support level at $40 according to technical analysis. If the stock were to approach $40 again and break it to the downside, this would be an indicator of a considerable move downward by the stock. The reverse is of course true for a resistance level. It is a certain price which the stock has approached and failed to move above.

 One last technique worth mentioning is that of “head and shoulders” patterns. This technique identifies price trends on a stock price graph which well, look like head and shoulders. That is, there is a middle section of higher prices above either the left or the right of the graph. The prices on the left or right are lower, but not considerably lower, thus yielding the “head and shoulders” effect. It is suggested by technical analysts that if the stock price breaks this pattern to one side or the other, it will yield a significant move in the stock price.

 While many people trade on such approaches mentioned above, these types of approaches are not without problems from the perspective of Austrian theory. The first is that it completely divorces investing from economically meaningful capital allocation. One allots capital to a firm because he expects it to break a head and shoulders pattern to the upside, not because he thinks it actually has a good business model. Some may criticize this point on the grounds that technical traders often have shorter time horizons than other traders, thus making the viability of the underlying business irrelevant. While such is undoubtedly true, this is not always the case. Certain types of technical traders will hold positions for several months or even longer than a year (Elmerraji 2011). At this point one would expect the profitability (or lack thereof) of the underlying business to be relevant. A technical position of longer length would therefore have to be more than just a short 2-day arbitrage process, making this criticism a fair point.

 A second problem with the technical approach is that it suffers from an over-reliance on mathematics and statistics, and thus marginalizes the effect human actors have in the marketplace. Prices will move up or down as a result of purposeful trading due to human action, not because the price has broken some technical indicator. Undoubtedly, some people’s trading preferences are in-line with that technical indicator, since they are using those techniques, but prices need not inevitably move one way or another as a result of breaking some key level. It overlooks the purposeful choices of actors in the market who have no regard for technical analysis[[2]](#footnote-2).

 A third criticism of technical analysis is that many of the techniques it uses are just purely arbitrary notions. How can one look at a chart graph and determine market support and resistance levels? One may disagree on what the support level actually is. Moreover, just because a certain price floor hasn’t been broken does not mean that the market actually supports the stock at that point. It may just be coincidental that the price hasn’t moved lower the few times it approached that price. Furthermore, there was a unique set of variables operable in the past which prevented the stock from going lower. Those variables will not necessarily be in play in the future, as is seemingly assumed by technical analysis methods. Technical analysis thus ignores historical particulars and fails to understand the uniqueness of entrepreneurial ventures.

Another problem with technical analysis is that it is essentially a deterministic framework which ignores acting human beings. It suggests that price moves are inevitable and minimizes, if not negates entirely, the free choices of investors in the investment process. Why should it be inevitable that a stock will drop further just because it fell below its 200-day moving average (Grimm 2009)? What is it about ‘breaking a key resistance level’ which actually makes the stock move up? Technical analysis proffers a sort of deterministic answer to that question, and implies that it was inevitable.

A final problem with technical analysis is that it simply has no theory behind it which links what actually happens in the market with what happens on the technical chart. That is, there is no explanation for why the technical trading phenomena take place (Grimm 2009). One simply assumes that funds will poor in to a stock if it breaks its head and shoulders pattern to the upside. Why? No explanation is proffered. Now it may be possible that certain patterns in trading could actually be reflections of human psychology. This is a topic for future research. However, as of now, there is practically no theory which explains this link between the chart and human choice.

**Quantitative analysis**

 Quantitative analysis utilizes modeling and statistical techniques to make determinations on what investments an investor should make. An example is the CAPM model, which I will use for my analysis.

The CAPM model specifies that the relationship between financial security return and risk determines the appropriate market-clearing price. The formula used for this model is as follows: Ra = Rf + B \* [MRP] or the return on an asset equals the risk-free return rate plus Beta times the market risk premium. The risk-free rate is usually something like a Treasury bill. Beta is a measure of a stock’s volatility in relation to the market. A Beta greater than 1 indicates higher volatility than the market while a Beta less than 1 indicates lower volatility than the market. The market risk premium is the expected return of the market minus the risk-free rate. In other words, it is your compensation for taking on risk (Bodie, Kane and Marcus 2010). This method allows one to tailor his stock selection in accordance with his risk goals. If he wants to take on little risk, he can concentrate on low-Beta stocks. If, however, he wishes to generate high investment returns, the CAPM model suggests investing in a diversified group of high beta stocks (Boettke 1998).

One chief problem with this model from an Austrian standpoint is its definition of risk. The CAPM considers risk in a security to be its volatility relative to the market. It “contends that a security’s required return has little or nothing to do with company and industry specific events for these sources of risk are simply immaterial as they are easily diversified away by investors” (Grimm 2002, p. 98). This quantification of risk is also criticized by Grimm (2012) in a later article, noting that unforeseen reactions, cognitive biases, and misinterpretations of data by market participants can also affect the amount of risk in a security. As a result, an investor can only, at best, subjectively assess the risks and uncertainties of a given stock in the investment process. Risk cannot be objective (quantifiable) as is assumed in quantitative models of investing.

This artificial quantification of risk and over-looking of subjective human action divorces this model from real world capital allocation, where once again it is statistical numbers that determine the success of a stock, not the underlying business model of the firm. Moreover, bound up in the model’s assumptions, is the idea that investors analyze securities in the same manner and have the same economic views (Bodie, Kane and Marcus 2010). Besides being obviously wrong from an empirical standpoint, this assumption mis-represents how trade works in the market. Participants engage in exchange because they have differing expectations on a stock, not the same expectations. Building a model on this faulty assumption gives it a very shaky theoretical foundation.

Additionally, the CAPM model is guilty of inappropriately extrapolating past trading results and statistical information into the future. The Beta measure relies on past data in its derivation[[3]](#footnote-3). Indeed, investment analysts will actually use Betas of a differing sequence of years. One analyst may base his Beta measure on an average of the last 5 years and another on the last 3 years. Either way, this is no guarantee of what the firm’s ‘volatility’ will be in the future. It is entirely possible that the stock’s Beta coefficient will change over time. Thus, high Beta stocks may underperform the market, whereas low Beta stocks may actually out-perform the market (Boettke 1998). Fundamental analyst Warren Buffett (2009, n.p.) succinctly criticizes this approach as follows: “If merely looking up past financial data would tell you what the future holds, the Forbes 400 would consist of librarians.”

Furthermore, building off these earlier points, the CAPM model fails to realize the uniqueness of entrepreneurial ventures, which eludes precise quantification and prediction. Entrepreneurial ventures change over time, which means their rates of returns and other financial statistics regarding these companies can dramatically differ. Trying to quantify correlations between industries, risk, and other statistics is simply fallacious, since the numbers will change. One cannot use this data, which will have its own unique set of historical particulars, as a sound basis for investing.

The final fatal flaw of the CAPM model – its arbitrary assumption that stock returns are normally distributed along a bell curve[[4]](#footnote-4). This means that the model assumes that entrepreneurial ventures which generate extreme returns, either very negative or very positive, are rare. Economic theory not only offers no justification for this belief; it would in fact seem to suggest the opposite. Entrepreneurs are tasked with finding mis-pricings in the market. If one is correct in his estimation, it would be expected that he would make significant returns for doing so, since he is the only one who discovered the opportunity.

**Conclusion**

 While there are many different approaches to investing, the only one that appears to be compatible with Austrian theory is that of fundamental analysis. This investment technique lines up nicely with what Austrians believe about risk, entrepreneurship, price and value, and other facets of economic theory.

Other investment theories, however, can be found to contradict Austrian theory on numerous points. The method of passive investing, based on the efficient market hypothesis, is perhaps the most notorious offender, as it runs contrary to Austrian theory on many points. There is no role for the entrepreneur in efficient market theory, since prices are supposed to be correct. The idea of the entrepreneur who recognizes under-valuations in the market is thus done away with. While the entrepreneur is ignored, so too are the later effects of credit expansion, which market prices immediately adjust to in the EMH model. The EMH also assumes that market participants can immediately assess consumer preferences, in addition to suffering from other theoretical failings, like the issues of unequal knowledge and varying news interpretations among market participants.

The method of technical analysis does not fare much better. Technical analysis likewise displaces meaningful capital allocation, and instead replaces it with charting techniques and statistical data. The stability and profitability of the underlying business is ignored. It fails to understand that unique variables determine market prices at different points in time, and thus inappropriately extrapolates past trading data to the current or future trading situation. It moreover follows a deterministic framework which negates human choices in the process of investing.

The CAPM model also runs awry on many points. Its conception of risk differs markedly from Austrian theory. It erroneously assumes that stock returns fit a bell-shaped curve, a view which has no basis in economic theory. It inappropriately extrapolates past data onto future trading events, assuming that this past trading data (betas, correlations, etc.) will remain constant in the future. It also can be said to commit the mechanistic fallacy of treating the economy and investing as something which can fit neatly into a model.

It is thus clear that if an Austrian were to choose one of these approaches to investing – passive investing, fundamental analysis, technical analysis or quantitative investing – he would undoubtedly choose fundamental analysis.

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1. There are three different versions of the efficient market hypothesis: strong form EMH, semi-strong form EMH, and weak form EMH. In this paper, when I refer to the efficient market hypothesis, I am referring to the strong version. Each version differs from the other and would require its own separate analysis. Some of the points I make in this section of the paper would still apply to the semi-strong form of the EMH, as well as the weak version of the EMH. [↑](#footnote-ref-1)
2. Again, I do not mean to suggest that there is no role for past data and statistics in trading. What I am criticizing here is technical analysis’s almost exclusive focus on these techniques. Fundamental analysts themselves also use past data, but this is only one piece of information incorporated with others which aids in making a subjective valuation of a stock price. Technical analysis, to the contrary, suggests trading is only statistical analysis and stock chart analysis. [↑](#footnote-ref-2)
3. Another potentially interesting question in regards to the CAPM model is how rates of return are calculated, meaning whether they are calculated in terms of calendar year or by some other method, and whether or not this even matters. It is little things like this within statistical models that can skew results and thus may warrant serious consideration. [↑](#footnote-ref-3)
4. Empirical research has also demonstrated evidence to the contrary on this point, but this is beyond the scope of this paper. [↑](#footnote-ref-4)