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Subjectivity, Arbitrariness, Austrian Value Theory, and a Reply to Leithner

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ABSTRACT: Contrary to the Austrian community's former perception, we revealed value investing's incompatibility with Austrian economics (Rapp, Olbrich, and Venitz, 2017). However, Leithner (2017) disagrees with this conclusion. He primarily argues that an analysis of value concepts should be neglected in favor of a discussion of the methods value investors apply to "measure" value to diagnose whether or not they adhere to Austrian value theory. Moreover, he claims that value investors use terms imprecisely and that *intrinsic value* is actually meant to be subjective, even conceptually. However, we believe Leithner's remarks suffer from fundamental misunderstandings and error. He is mistaken on Austrian value theory, subjectivity, and the conceptual foundations of value investing. Therefore, we gladly accept the offer to address his misapprehensions and to sharpen the Austrian understanding on investment decisions in general.

KEYWORDS: Value investing, Austrian economics, value theory, intrinsic value, subjectivism, arbitrariness

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I. CONCEPTUALIZATION AND (IM)MEASURABILITY OF VALUE

In a paper previously published in this journal (Rapp, Olbrich, and Venitz, 2017) we debunked the myth of an alleged compatibility between value investing and Austrian economics. Unsurprisingly, one of the advocates of that myth, namely Leithner (2017), disagrees with our conclusion. Apart from both untenable allegations[1] and demonstrably incorrect claims,[2] his critique can be cut down to the following main argument: Leithner (2017, p. 172) rejects the emphasis we put on the fundamental conceptualization of value while favoring an analysis of "the concrete method by which the investor *measures* a given security's value" to conclude whether or not he adheres to the subjective theory of value. Moreover, Leithner (2017, p. 175) alleges that value investors use terms, in particular the crucial term *intrinsic value*, "sloppily" but that what they "label 'intrinsic value' is, both conceptually and empirically, actually subjective." Alas, Leithner's remarks suffer from fundamental misunderstandings of and even some unfamiliarity with Austrian value theory, subjectivity, and value investing's conceptual foundations. Therefore, we gladly embrace the opportunity to discuss Leithner's critique in this reply to shed some light on the issue. By so doing, we seek to sharpen the understanding of both Austrian value theory and subjectivity in the context of investments, not least among the Austrian-friendly community of practitioners.

Leithner (2017, p. 172) criticizes us for solely discussing and

[1] Specifically, Leithner (2017, pp. 173–174) accuses us of overlooking important personalities and their work, one of whom is suggested to be John Burr Williams. However, we did not overlook anyone; our list of references is rather extensive. The reason for not citing Williams, for example, in our original paper is quite simple. We addressed the question of conceptualization of value rather than methods of investment appraisal. Williams did not contribute anything new to the former and, hence, his work is of no importance to our initial discussion.

[2] For instance, Leithner (2017, p. 174) falls for the misconception that "John Burr Williams [...] wrote the first treatise that systematically applied the insights of the marginal revolution to the conceptualisation and measurement of securities' values." However, Williams's (1938) treatise is neither the *first* of its kind nor is it—compared to its predecessors—*systematic*. For an earlier and more systematic treatise of the application of marginal utility to investment appraisal see, in particular, Liebermann (1923).

contrasting value *concepts* rather than dealing with the technical application of methods with which "the investor *measures* [...] value." He incorrectly believes that "if they did then they would undermine their key contention" (p. 172). However, the *actual* reason why we purposely focus on the conceptualization of value at the expense of what Leithner (2017, p. 172) refers to as "measurement" of value is twofold. First, Austrian economists not only pointed out that value is necessarily subjective; they also revealed that subjective value is inevitably *immeasurable*. For instance, Mises (1953, p. 38) unambiguously explains:

> So long as the subjective theory of value is accepted, this question of measurement cannot arise. In the older political economy, the search for a principle governing the measurement of value was to a certain extent justifiable. If, in accordance with an objective theory of value, the possibility of an objective concept of commodity-values is accepted, and exchange is regarded as the reciprocal surrender of equivalent goods, then the conclusion necessarily follows that exchange transactions must be preceded by measurement of the quantity of value contained in each of the objects that are to be exchanged. And it is then an obvious step to regard money as the measure of value.

Therefore, if one accepts the Mengerian, subjective notion of value, one necessarily has to regard "[a]cts of valuation [...] [as] not susceptible of any kind of measurement" (Mises, 1953, p. 39) since there "is no [...] objective unit in the field of human valuation" (Rothbard, 2009, p. 19). Mises (2012, p. 9) notes: "Marginal utility does not posit any unit of value" and, thus, "the notion of a measurement of value is vain" (Mises, 1998, p. 205). The very fact that Leithner claims value investors (including himself) can and do *measure* value reveals both fundamental ignorance of one of the most basic cornerstones of Austrian value theory and sympathy for objective concepts of value due to their characteristic of being amenable to measurement.

Second, the underlying conceptualization can never be sidestepped in a serious and informed discussion about value. The question of whether or not particular methods of investment appraisal[3] (which Leithner perhaps has in mind when erroneously

[3] Herbener and Rapp (2016) not only present an Austrian approach to investment appraisal but also relate it to Austrian value theory.

discussing the "measurement" of value) serve their purposes, for instance, is inseparably linked to the concept of value (Schmalenbach, 1926, p. 297; Schmalenbach, 1956, p. 138; Matschke and Brösel, 2013, pp. 49–50). If the calculation is supposed to follow a hypothetical objective value concept, for example, for fiscal matters, methods resulting in highly subjective numbers are inadequate. In contrast, if the appraisal aims to provide a presumptive investor with his highly individual barely acceptable price, methods seeking to assess, for example, an objective "market value"—as attempted by prevalent contemporary DCF models springing from neoclassical finance theory—obviously fail (Matschke, Brösel, and Matschke, 2010, p. 35; Brösel, Matschke, and Olbrich, 2012, pp. 241–242; Matschke and Brösel, 2013, p. 50; Hering, 2014, p. 297; Herbener and Rapp, 2016, p. 22). In any case, analyzing methods of investment appraisal independently of the underlying value concept is pointless. Alas, Leithner (2017) overlooks the fact that methods of investment appraisal can only be judged in light of the underlying value concept, and mistakenly suggests instead that analyzing the process of "measuring" value alone allows for a conclusion regarding the underlying nature of value. Yet following Mises's above-mentioned quote, the only thing the attempt to "measure" value reveals is the inconsistency with subjective value theory. Generally, the relevant object of analysis in contrasting Austrian theory with value investing's foundations, however, is to be found in the underlying conceptualization of value only.

II. OBJECTIVE VALUE AND "SUBJECTIVITY"

According to the concept of value investing, a firm's (or rather a share's) *intrinsic value* and its market price should equate to one another *theoretically*; however, primarily investors' emotionally driven behavior (mistakenly termed "irrational") is seen to cause temporary deviations—either "overvaluations", that is, the market price exceeds intrinsic value, or "undervaluations", that is, intrinsic value exceeds the market price.[4] Whenever such temporary periods

[4] Bildersee, Cheh, and Zutshi (1993, p. 198)—empirically studying Graham's net current asset value approach—note: "They [fundamental analysts] believe that stock prices sometimes deviate from 'fundamental value'; the *true* underlying value that the security *should have* in the market, if *properly valued*" (italics added).

of investors' seemingly "irrational" actions come to an end, the market price is believed to approximate the share's intrinsic value because of the "inherent tendency for these disparities to correct themselves" (Graham and Dodd, 2009, pp. 69–70). Value investors try to make a profit from this alleged relation by investing in temporarily "undervalued" companies whose share prices are supposed to rise.[5] In sum, while market prices can and do deviate from intrinsic value, they are believed to consistently tend toward intrinsic value which is, therefore, deemed to be the *fundamental yardstick* of price trends. Value investing's conceptualization of value is hence purposely objective.[6] If intrinsic value was meant to be subjective—despite the term's apparent meaning—by contrast, the market price would either have to oscillate around thousands of "intrinsic" values resulting from different market participants' subjective appraisals of one and the same share at once, which is evidently impossible; or alternatively, the market price would have to oscillate around one particular subjectively appraised "intrinsic" value. However, *which* of the thousands and thousands of subjective appraisals for the very same share would then cause the market price to oscillate? *Why* should one particular subjectively appraised "intrinsic" value cause the market price, which can be the outcome of thousands and thousands of independent valuations, to oscillate? Hence, if intrinsic value were indeed a subjective concept, the very idea of value investing would go up in smoke. Leithner (2017, p. 175) seems to not even get these conceptual foundations of value investing right and, hence, is demonstrably in error when he alleges that what value investors "label 'intrinsic value' is [...] conceptually [...] actually subjective"—nothing could be further from the truth.

One thing Leithner (2017, pp. 175–176) correctly realizes, though, while referring to both John Burr Williams and Warren Buffett, is the fact that different value investors will arrive at different figures when trying to appraise a particular share's intrinsic value.

[5] Value investor Vick (1999, p. 8) asserts "that undervalued situations, by definition, must end sometime."

[6] Vick (1999, p. 4) emphasizes that "the notion of intrinsic value is *not subjective* but generic […] In the absolute sense, intrinsic value is the *real worth* of a company, the sale price investors could reasonably place on the company if they all possessed the same information and insight" (italics added).

However, he misdiagnoses this fact as the result of the appraisal's subjectivity and, hence, is barking up the wrong tree again. Value investing requires the assessment of a certain share's intrinsic, that is, its one and only "true value" (Graham and Dodd, 2009, p. 69). Yet intrinsic value is nothing but a mere *phantom*.[7] The fact that such a phantom cannot be properly grasped by nature, however, does not at all allow for the conclusion that the concept of intrinsic value was actually subjective. Rather than subjectivity, intrinsic value's non-existence causes differing appraisals among value investors. How could it be possible for independent investors to assess a particular figure equally if that figure does not even exist, and, hence, is incalculable? Apparently, the appraisal of intrinsic value is *not* subjective in the sense that it considers a particular individual's actual (financial) ends and means guiding his actions; because intrinsic value does not exist and, hence, value investors stumble about in the dark when trying to appraise it, instead, it is nothing but entirely *arbitrary*.

The essential fallacy inherent in Leithner's reasoning can be illustrated by analogy with the cost/labor theory of value as similarly applied by both classical economists and Marxists (Mises, 1998, pp. 204–205). While they undoubtedly "shared the desire to objectify value" (Cole, 2010, p. 216), different appraisals will result in differing figures too. For example, if a particular product requires certain input factors on a large scale (such as screws) that were obtained over a period of time at various costs, one has to pragmatically assess an average cost which will—due to plenty of possible ways to make the calculation—result in differing numbers. The same applies to both the allocation of overhead costs and the selection of the method of depreciation employed for the involved manufacturing tools. Not least, time spent to manufacture the product can be calculated to the split second or one might consider only full hours, for instance. However, does that space necessarily resulting in differing figures lead to the conclusion that the Marxist theory of value is conceptually actually subjective and, therefore, resembles the Austrian perception? While Leithner's reasoning strongly suggests this conclusion, thus revising the history of

[7] As Mises (1998, p. 96) puts it: "Value is not intrinsic, it is not in things." Value investing's perception of value, therefore, must be characterized as "the naive concept of the layman" (Ritenour, 2016, p. 192).

economic thought, it is evidently fallacious. Both Marxism and value investing purposely apply objective perceptions of value; yet the attempts to appraise such value are, owing to its absence, solely characterized by *arbitrariness*.

III. SUBJECTIVE VALUE AND SUBJECTIVITY

Contrary to the conceptual foundations of value investing, Austrian analysis holds that it "is ultimately always the subjective value judgments of individuals that determine the formation of prices" (Mises, 1998, p. 329). Menger (2007, p. 120) emphasizes that the "value of goods arises from their relationship to our needs, and is not inherent in the goods themselves." Intrinsic value is, hence, considered an erroneous belief (Ritenour, 2016, p. 192). Rather than a company's one and only "true, intrinsic, or ultimate worth" (Greenwald et al., 2001, p. 26) fundamentally determining price trends, Austrians have pointed to the fact that it is indeed the *inequality* of values causing exchanges and, thus, prices (Mises, 1998, pp. 328–329). In valuing two alternative courses of action, such as buying or abstaining from buying a particular share, an investor compares the benefits associated with both alternatives and ultimately ranks them in light of his ends (Mises, 1998, p. 94). A financial investment decision, then, requires knowledge of the *marginal price* the investor can just barely accept without suffering an economic loss as prerequisite for a nonarbitrary valuation (Herbener and Rapp, 2016, pp. 10–11). Such marginal price is not an objective indicator, and is even less reflected in intrinsic value; instead it will differ both from individual to individual and as time passes, because it is determined by a particular person's alterable (financial) ends and means (Hering, Toll, and Kirilova, 2015, p. 24; Olbrich, Quill, and Rapp, 2015, p. 20; Rapp, Olbrich, and Venitz, 2017, p. 16). Hence, a genuine investment appraisal aiming to arm an investor with his barely acceptable price needs to take that individuality into account. Time preference makes it necessary to place a discount on future satisfaction (Herbener, 2011, p. 14; Herbener, 2018). Consequently, investment appraisal must discount an investment's expected future benefits, that is, it must rely on the present value technique. The subjective nature of value and, hence, of a genuine investment appraisal is, then, reflected in a threefold manner (Herbener and Rapp, 2016,

pp. 16–18, 19–20). *First*, the projection of future earnings is inevitably subjective due to both the necessity to form expectations given uncertainty and individually differing financial circumstances, particularly tax rates, tax loss carry-forwards, and the potential capability to control corporate policy as well as to gain from synergies if, for instance, an investor already owns one of the target firm's competitors. *Second*, the only correct discount rate on imperfect—that is, real—capital markets equals the internal rate of return of a particular investor's best alternative application of funds, either another investment or the settlement of a loan (fundamentally Schmalenbach, 1908/1909; Hering, 2014, p. 29). Since an individual's best investment or funding alternative is determined by both that person's financial ends reflecting his time preference and the overall pool of investment and funding projects available to him, it will necessarily differ from individual to individual. *Third*, uncertainty is an obstacle to optimal problem-solving; investors can only rely on heuristics. Contrary to the popular but fundamentally flawed risk premium concept (Hering, 2017, pp. 292–310; Hülsmann, 2018), one promising approach to structure uncertainty's effects associated with an investment lies in the application of a Monte Carlo simulation (Hertz, 1964, pp. 95–97; Coenenberg, 1970, pp. 793–795). Both the forecast of future earnings and discount rates as well as the selection of the final marginal price out of the distribution provided by the simulation, then, are subject to highly individual entrepreneurial judgments.

Leithner's (2017, pp. 172–173) summary of methods he and his fellow value investors apply to "measure" value, therefore, exposes nothing but the methods' fundamental uselessness. Appraising "a company according to the external prices of its assets" (p. 173) is in fact flawed in three respects (Olbrich, 2000, p. 454; Rapp, 2014, p. 1067).[8] *First*, it entirely disregards a particular investor's subjective ends and means, such as his planning horizon or alternative available financial opportunities. *Second*, it neglects the significance of both a future-orientation and combination effects as it exclusively considers the sum of past or present prices of individually appraised assets rather than the future earning power of the company as a whole. *Third*, it conflates two inevitably

[8] Schmalenbach (1917/1918, p. 6) already uncovers such a procedure as a bad blunder.

distinguishable things, namely values and prices. Leithner (2017, p. 173) also errs when he alternatively suggests using "some rate" to discount (undefined) "cash flows [...] to the present" in a DCF appraisal. As outlined above, there is only one correct discount rate for genuine subjective appraisals; nor is it proper to apply "some rate", and nor does the discount rate reflect an "opinion" investors "believe in" as claimed by Williams (1938, pp. 16–17) whom Leithner (2017, pp. 174–175) invokes prominently. It instead stems from a sound causal chain deduced from the concept of marginal utility by advocates of investment theory developed in the German-speaking world whose lineage is *consistently* traceable to early Austrian economics (Schmalenbach, 1919, p. 334; Schmalenbach, 1937, p. 27; Matschke and Brösel, 2013, p. 6, fn. 11; Hering, 2014, pp. 27–28; Olbrich, Quill, and Rapp, 2015, pp. 15–16; Herbener and Rapp, 2016, pp. 12–13). Hence, while Leithner (2017, p. 175) seems to acknowledge the Austrian perspective when he explicates that value stems from "the importance an acting individual places upon the good (security) for the achievement of his desired ends," he clearly is grievously mistaken on the methods he considers proper in preparing investment decisions from an Austrian perspective.

Needless to say, in conclusion, value investing remains fundamentally at odds with the Austrian school.

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