

*An Austrian Approach to Investing*

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David Hannibal

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## **Abstract:**

*In the post Lehman Brothers stock market crash, investors and individuals are looking for a new and better way to understand the market and how to invest. It is clear that pure numerical analysis has not been able to accomplish this. The financial approach of technical and quantitative analysis to forecast the future has continued to fail man once again. Many individuals and investors realize the failures to this approach and therefore are looking for a new way to base their investments on. Austrian economics has been proven to be the correct approach to the market and therefore investors should look at Austrian economic principles and theories. By using and understanding Austrian economic principles on business cycles, interest rates, inflation, government coercion, human action, preferences, valuation, time, and monetary action, the investor will be able to forecast the market better than the non-Austrian investor, the CFA, and the CFP.*

*Man should not invest due to only Austrian views or only CFA and CFP analysis. Man must recognize cash flows, financial statements, a stock's alpha, and its beta. The strict numerical side of investing should be used to find the market price and value of the firm through fundamental analysis. No Austrian should invest solely on business cycle theory, interest rates, or praxeology, as they will only lead him in the right direction. Rather, fundamental analysis bridges the gap to allow the Austrian to make a more complete investment decision. Through the use of fundamental analysis, to understand the basic numerical ideas of indexes and corporations, and Austrian economic theories and principles, an investor will truly be able to forecast the market better than any other investor to therefore realize the greatest gains in the market.*

## **Introduction:**

The investment community looks to Financial Analysts and their reviews and corporate reports to make investment decisions. Although looking at a company's financial breakdown is important, as is looking at its alpha, beta, standard deviation, and r-squared, it is not the only way, or the best way, to base an investment decision. The Austrian School of economics teaches beyond what those numbers can, as they show time value, trends, business cycles, and praxeology. Since the collapse of the market in 2008 investors have looked to other avenues for basing their decisions off of. That is why there is great importance in taking the theories of Austrian economics and applying them to investment decisions, portfolio creation, hedge funds, and mutual funds. The concepts of Austrian economics, when used by the investor, will allow them to not only understand the market better, but also invest wiser. The result will be larger gains, less risk, and a better understanding of where to invest due to government coercion.

## **Foundation of Investing:**

This topic is of utmost importance, as Austrian economics is on a rise in economic thinking. This can be seen through the increase in blogging, writing in profession journals, or looking at website traffic since 2008.<sup>1</sup> As a result of the increase in interest, a mass confusion of investing strategies, methodologies, and investors, and a drastic change in the market, it is a perfect time for Austrian economics to play a major role in not only policy formation, but also the way people invest their. A Financial Report, an analyst's review, or corporation's outline are great ways to understand

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<sup>1</sup> The Mises Institutes' website traffic is up 80% as of July 4<sup>th</sup>. Adam Sharp. "Austrian School on the Rise." Bearish News. <http://www.bearishnews.com/post/1204>

whether or not to invest in a corporation, however, understanding time value, business cycle theory, trends, and praxeology allow for a better, well rounded understanding of the market, its volatility, corporation's volatility, trends, and therefore risk management.

It is of utmost importance to start from the beginning. One cannot start a discussion of knowing how to invest without first understanding the one investing, the human, acting in the manner of taking his savings and putting it to use through investment. Rothbard states in *Man, Economy, and the State* that human action is “purposeful behavior.” Mises uses the term praxeology, the logic of action, for the branch of knowledge that is exemplified by science of economics describing human action.

Mises says of the science of economics:

“Its statements and propositions are not derived from experience. They are, like those of logic and mathematics, a priori. They are not subjects to verification and falsification on the ground of experience and facts. They are both logically and temporally antecedent to any comprehension of historical facts. They are a necessary requirement of any intellectual grasp of historical events.”<sup>2</sup>

Therefore, all economic forecasting, or investing, is constrained by the existence of a priori knowledge about human action. With this, Mises creates praxeology as the foundation of epistemology.<sup>3</sup> This is based off of the concept that man acts with meaningful behavior, that he acts towards an end by his means, through his individual motives, and with the understanding that the future is uncertain. However, it is important to note, that one cannot take action and create causal prediction, as this is not true knowledge. Rather, with the foundation of knowledge being praxeology, one can deduce claims about future action. Claims such as “if A occurs than B will be the result.” In

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<sup>2</sup> Ludwig Von Mises, *Human Action*. Page 32.

<sup>3</sup> Hanns-Hermann Hoppe. “Economic Science and the Austrian Method.”

terms of investing this is of utmost importance, as it will play a major role in predicting the future movements of investing, man's actions in the market, and market trends.

Being able to deduce claims about future action is of great importance to investing in light of budgetary constraints. Investors do not have unlimited capital to use for investment, therefore they must make decisions of how many of security A they want in comparison to B, C, D, or E in their portfolio to create the greatest gains. By man acting in the market and trading his good for another, he is making a value judgment. By this he is ranking his ends in accordance with his means. He does such to create the most utility by the means he has to deploy (in a state with money this would be his budgetary constraint). And by employing his means to different ends he is in fact using his action to exchange a less satisfactory state for one with more satisfaction.<sup>4</sup> And by this, he therefore ranks his means in accordance with their value (each dollar is ranked differently, in accordance with its marginal utility). By this principle, man shows his value of each good by the amount of dollars he is willing to spend on it, therefore allowing for an economist to compare their utility. Utility moves from higher-order producer goods to lower order producer goods to consumer goods.<sup>5</sup> Therefore each good has marginal utility, or amount of utility one would give up to increase the amount of utility in another. By this constraint on the budget or on the portfolio, an investor must invest. They must invest with the understanding that as the quantity of the supply of a good increases (supply of shares on the market), the utility (the value of the shares on the market) of each additional unit (share) decreases. This economic principle highlights how, as people look to sell more shares, with each additional share on the market, the

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<sup>4</sup> Murray N. Rothbard. "Man, Economy, and the State with Power and Market." Page 19.

price decreases. It is clear that simple Austrian principles not only effect the regular buying and selling of goods, but also the securities of corporations on the indexes and exchanges.

This idea, of ranking ends in accordance with the investor's means, is a preference scale. This preference scale is a value difference. Each end on the preference scale is at a different level of value and therefore fulfills a different level of utility. Man will therefore act at the preference that brings him the most profit. The Austrian concept of applying means to highest-valued ends, then to next highest, and so on, is the same as the investor using their capital along their budgetary constraint. Austrian economics highlights how man will use his means to his highest-valued ends, then to next highest, and continue in such fashion along his preference scale. This same concept is applied to the investor. By the investor investing in security A before B, C, D, or E they are showing a financial preference and therefore exemplifying the value that they attribute to fulfilling each end on the preference scale.

Investing goes beyond just number crunching, as it must acknowledge Austrian principles about man, his action, and his creation of value. A corporation looks to create a product that consumers want to purchase (creating value in their firm), as the consumer views that product as a way to fulfill their ends by using their means. Therefore, the producer values the consumer's dollars higher than his product and the consumer values the product higher than the dollars. If this is so then trade will exist (assuming a lack of government coercion). In the same way, one will not invest in a corporation, by using present dollars to get a larger amount of dollars back in the future, that they do not find to be of higher value than the dollars used to purchase a share of the corporation. The stock

market is simply a market of an owner of the share selling his good in exchange for something he values more, dollars, and the consumer looking to buy the share in exchange for his dollars. This transaction, on a mass scale is what drives the prices of shares up and down of a corporation. They are driven by each trader's personal marginal utility of that specific share of the corporation. It is important to remember that marginal utility is driven by an individual's value rankings in accordance with his action of attaining ends by some means. This exemplifies the necessity to look at the increase or decrease of share prices being as a result of an individual's valuation of the corporation and shares.

Looking at a corporation, evaluating it, and creating a basis of whether or not to invest takes time. Time also is reflected in the span it takes for a buyer and seller to make a transaction and find each other.<sup>6</sup> As time changes, from previous to present to future, all are valued with a different standard of time. In the past, one could view time as a span of history, but it cannot be viewed on a corporation's financial books. In the present one views time as buying now or later, buying in the present or future in the system of exchange. Therefore, one takes into account the value of a corporation, and buying stock in it, in terms of present or future time, or whether to buy in the present or wait until a future date in time.<sup>7</sup> Time is in every exchange and transaction.<sup>8</sup> And it then must set a new equilibrium. Clearly the statement "time is money" is correct, because an investor

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<sup>6</sup> Ludwig Von Mises. "Human Action." Compiled and edited by Bettina Bien Greaves. "Austrian Economics: An Anthology." Page 132.

<sup>7</sup> Time is looked at in terms of interest by the investor. However, in this case, although time, and specifically future time, is given out in terms of percent gained on interest by the investment, that is not what this means. Rather this specifically is referring to the variable of time and looking to understand the importance of time in investing and its results. It means that if an investor buys security at time A, the price is X, but at time B the price is now  $X_1$ .

<sup>8</sup> Ludwig Von Mises. "Human Action." Mises.org

views present or future time more or less valuable to invest in. This valuation results in a new price equilibrium of the traded shares.

### **Austrian Investment Value:**

When a corporation is valued at a larger price than the current traded share price, buyers will bid the price up by buying more shares, this exemplifies the Austrian idea that the market price shows the minimum amount that people who buy the shares are willing to pay for more shares. Therefore, because individuals are bidding the prices of the shares of the corporation and trading them in the market, each one values them individually, and more importantly subjectively. Hence, the price of a corporation on the exchange is always changing, as individuals always are changing their subjective value of the corporation with new information, ideas, or knowledge they have of the industry, sector, market, economy, or other external factors. The subjectivity of valuation by the investor is of utmost importance, as there lies the basis for forecasting. An individual forecasts by what they personally feel will happen to the economy, market, sector, industry, and therefore corporation. By looking at a corporation's books, looking at the financial analysis, and looking at the alpha and beta cannot alone be the way to invest, as there is a subjective thought process that decides whether to invest or not, and to what extent (by use of how much money to invest). Therefore, forecasting is subjective.<sup>9</sup> The fact that forecasting is subjective, because it is done by man who values a firm by buying shares of it to fulfill his valued ends by his means exemplifies the subjectivity of his actions. If

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<sup>9</sup> Forecasting is subjective as it is correct to the beliefs of an individual and may not be correct. It is pure speculation of the future. The individual making the forecasting is just inferring and predicting about what they think the future will be.



valuation was objective, and therefore the future value of a corporation was objective, instead of subjective, than all the quantitative data, statistical information, and pseudoscientific models would always work and predict the market. However, because this information does not predict correctly every time, or most of the time, this information cannot be taken as fact, but rather as just another subjective perspective one can choose to base their investments on.

Subjective value of each man's actions results in the investor needing to not only having a quantitative understanding of the market, i.e. statistical and numerical analysis of the corporation and the market, but also qualitative understanding of other investors, and more importantly the subjective values of groups of individuals and large investment groups. By understanding the market environment, and their views of the market environment, the Austrian investor will be able to have a clear view of how to invest and save. Unfortunately, due to government coercion in the monetary system, the rate of interest is not free from manipulation, and therefore one needs to have an understanding of the Austrian theory of the business cycle.

### **Business Cycle Theory:**

There is a cycle that exists because of government intervention in the monetary system that is damaging and ineffective. The central bank forces interest rates too low for too long, always having the same result, excess credit creation and speculation. The result of over speculation and credit below market equilibrium is the pattern of economic booms and busts as the market is coerced by the central bank. Henry Hazlitt said this about the problem, "the economic future, like the political future will be determined by

future human behavior and decisions. That is why it is uncertain. And in spite of the enormous and constantly growing literature on business cycles, business forecasting will never, any more than opinion polls, become an exact science.”<sup>10</sup>

The cyclical fluctuations, which the economy will always go through and will always be exemplified by a boom and bust, have four phases. During the boom, the economy will experience growth faster than the normal trend. This is a result of the central bank increasing the supply of credit by forcing interest rates lower than the market equilibrium. Because rates are lower, the purchasing power of money will decrease, which will increase stock, bond, and real estate prices in addition to building up the capital structure. The result of all of these actions is entrepreneurial error exemplified through malinvestment. This boom will turn into a crisis period where the market turns from the boom to a bust. The crisis is not seen correctly, as the market is always ahead of the actual economy. Therefore, although the market will begin to show malinvestment, consumers will experience a time of great reward due to entrepreneurial investment in producer goods. This is a true contradiction of where the market is and where the consumers are in the economy. The interest rates will increase and the purchasing price money will be clearly seen, resulting in losses. The bust will then exemplify the faults of monetary coercion by the government and be a market downturn and result in slower growth than the trend. The malinvestment that was seen in the boom and began in the market then will now take place in the entire economy and the market will begin to sell off production to shorten the capital structure. This period will be clearly seen through bank failures. The recovery will result, being exemplified by the market starting to come

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<sup>10</sup> Graeme B. Littler. *The Truth About Economic Forecasting*. “The Economics of Liberty.” Page 66.

out of the bust and entrepreneurs starting to create producer goods once again. The recovery, which happens after liquidation is complete, brings interest rates and the purchasing power of money to equilibrium. Credit expansion and contraction will now be equal in equilibrium again which allows capital value to return to normal, compared to the volatility of the boom and bust time period.

Business cycle theory is the most important aspect for an Austrian investor. These four periods are clearly outlined on every cycle and therefore are outlined on every index and stock exchange. Therefore, this is the best tool that one has for forecasting. It is important to note that most forecasters fail, and fail the majority of the time. The greatest example is when everyone miss-predicted the 1982 recession and the employment boom to Crash of 1987 time period.<sup>11</sup> The reasoning was that most looked to the past to suggest the future. This is still the same problem. As Austrian investors, one needs to maintain the constant notion that there are no constant relations in human affairs.<sup>12</sup> Human actions, their motives to act, and values change every moment. Therefore forecasting markets cannot be based on mass equation models or science, rather through understanding praxeology, as man is qualitative and not quantitative. Rather investors need to use their entrepreneurial judgment to anticipate consume tastes and preferences along market conditions. The forecasting that can only be done, is that of looking to business cycle theory, which in of itself is not really forecasting as it will always existing when the monetary supply is under government coercion.

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<sup>11</sup> Littler. Page 67.

<sup>12</sup> Littler. Page 67.

Business cycle theory teaches and exemplifies how one should and when one should invest.<sup>13</sup> (Although, specific timing to when it will turn from bull to bear is still a guess and has nothing to do with understanding business cycle theory and applying it.) It therefore teaches how to invest in commodities as the rise and fall of the market. It shows when it is wise to buy gold and when to sell because of the boom or bust going to occur in the market. It shows that indexes will move with the cycle of business and that as interest rates are forced below equilibrium and loans are over extended, commodities are always going to hedge a portfolio against inflation. (For example, in the last boom-bust, as the market continued to drive higher until its crisis with bank failures and Lehman failing, oil, gold, and other minerals raised higher. With the turn of the boom to bust they decreased in value, but not down to their previous before-boom level. It is surely a great hedge against inflation as it is always equated against currency and will never be devalued like a money market account or a firm that goes bankrupt.) Most importantly, business cycle theory shows that a boom can never continue forever, and therefore allows investors to anticipate and be prepared for the eventual sell off. Being able to closely show when the market will turn from bull to bear is important, and therefore, using the business cycle theory will allow one to anticipate these movements based on theory and praxeology. Mises notes that businessmen cannot determine when the business cycle will change from a boom to bust, however, they can watch the news and read about interest rates, unemployment, and other signals. (The other signals are the laundry list mentioned that Hayek will later flush out in more detail in 1984.) Although reading news and

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<sup>13</sup> The when and how part of investing are exemplified by Hayek's extension of business cycle theory, where he adds numerous proposition after the boom-bust of the 1980s. These additions help one to better understand when the boom turns to crisis and bust to recovery. F.A von Hayek "Money, Capital and Fluctuations, early essays."

looking at other signs just show the current market and do not show the future, as the investor looks to beat the rest to the best market forecasting, Mises notes that the Austrian can better judge the market because of knowledge of the business cycle, its proven results, and changes in interest rates.

### **Interest Rates:**

The fluctuations of the interest rate is key to business cycle theory. It plays a major role in and when to invest. The natural rate of interest is the rate at which real capital good are exchanged, predating the use of money. Wicksell, in 1898, realized that any increase or decrease in the money supply would lead to a change in the actual distribution of the individuals' cash holdings and spending.<sup>14</sup> The result is a change in prices. However, with the introduction of the banking system, the central bank, money, and eventually fiat money, the price of borrowing money has become lower than the marginal benefits of investment goods. This extra investment in goods results in malinvestments. Therefore capital needs to be allocated in the right effect, a concept that would later be called the capital-allocation effect by Ludwig von Mises. This concept looks to detail how individuals, and mainly entrepreneurs use their financial resources and divide it along means of production, other sources, and projects. The goal is to generate a maximization of wealth, however, due to interest rate coercion by the central bank, this can result in the malinvestment. The result, as Hayek notes, is that decisions as regards to investment, will be based on false information due to a distortion in the market

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<sup>14</sup> Rudy van Zijp "Austrian and New Classical Business Cycle Theories." Page 19.

rate of interest. The decisions will be non-optimal and the result will be overinvestment in too capital-intensive productions.<sup>15</sup>

The increase in interest rates by the Fed is said to be the major player in the business cycle recession and crunch time of the market due to its previous actions of interest rates being lower than market equilibrium. However, it should be noted that this is not the only factor; rather changes in input prices play an equally sized role. Increasing input prices are needed to cause an economic downturn.<sup>16</sup> Cwik notes that price change by inflation and work by the Fed result in a change (inversion) in the yield curve four to five quarters before a recession.<sup>17</sup> (For example, the yield curve inverted in January 2006 and May 2007, highlighting the coming September/October 2008 crunch/bust of the market.<sup>18</sup>) Many non-Austrians use the inverted yield curve, as it is a finance tool utilized by the Federal Reserve and banks, but the Austrian should use it in combination with Austrian theory on knowing if the Fed increases the Federal Funds target rate, a credit crunch will exist. When seeing such action by the Fed, the Austrian should look to utilize the curve to see the coming inversion. This will allow the Austrian to better predict the coming recession and crunch in the economy.

### **Government Coercion:**

In addition, investors need to look at where the government is using coercion and use Austrian knowledge to invest in a financially benefiting way. When the government

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<sup>15</sup> Rudy van Zijp “Austrian and New Classical Business Cycle Theories.” Page 68-69.

<sup>16</sup> Paul F. Cwik “Austrian Business Cycle Theory: A Corporate Finance Point of View.” *Quarterly Journal of Austrian Economics*. July 29, 2008. Mises Institute. Page 67

<sup>17</sup> Paul F. Cwik “Austrian Business Cycle Theory: A Corporate Finance Point of View.” Page 65.

<sup>18</sup> The yield curve is the relation between the interest rate and the time to maturity of the debt for a given borrow at said currency. The inverted yield curve exists when long-term yields fall below short-term yields.

is using coercion in the monetary system and forcing interest rates below market rate, Austrians need to take heed of their knowledge of money system and business cycles. During this time period of suppressed interest rates, corporate, municipal, and government bond rates are extremely low. As a result, an investor should look to the stock market and commodities. Because of the interest rates being below market level, the purchasing price of money decreases, which will increase commodity prices and stock prices. In another words, the decrease in interest rates will increase the present value of assets (stocks and commodities) and decrease the purchasing power of money. This is the most common way of intervention that will always be seen.

Looking at government coercion is a way to invest smartly, by looking at specific industries under coercion and always following interest rates in the business cycle. The government uses coercion through policy and legislation for different industries, whether inflation which results in an increase in prices and devaluation of the currency, Fannie and Freddie which results in the increase of housing production, subsidies to farmers which results in the increase in commodity prices, tariffs on imports which results in helping those firms that produce such goods in competition, laws on firms for accounting which results in increase in demand for accounting firms, and the list continues almost indefinitely.

Inflation, which is an ongoing rise of the economy's price level of an extended time, greatly impacts where one should invest. If the government prints money, uses open market operations, or any other ability to increase the amount of currency in circulation, it always results in a devaluation of said currency. The result will always be a decrease in the value of the currency against gold and other currencies and an increase in commodity

prices. The best way for an investor to hedge against this is to either buy foreign currencies or goods that are known to protect against the devaluation of the currency, like gold. Buying allows the investor to maintain the purchasing power of money they had previously before the inflationary time period began.

With the creation of Fannie Mae and Freddie Mac, these government sponsored enterprises, individuals who were not able to get a mortgage loan because of bad credit were now able to purchase a home through rates below equilibrium. The result was an increase in the housing market. The sub-prime mortgage market, recently exemplified in the 2008 crash, allowed for the great housing expansion movement. By more individuals being to own their own home, more homes were built. This drove material goods up, increased the value of corporations such as Home Depot and Lowes, and increased the prices of homes. The Austrian investor, seeing the increase in mortgages to those not credit worthy had key major abilities: play the boom of the housing market and invest in those areas of materials and corporations, and better anticipate the coming crash due to interest rates being too low for non-worthy individuals. Therefore, they can increase gains on the boom and protect themselves on the bust/crash because they would understand that the financial industry would be hurt the most.

A subsidy, whether to the farming industry, or to any other group of producers, will result in an increase of income for those under the subsidy and a decrease in price for those who consume the subsidized good at the expense of those who are not in those categories. A subsidy will shift the demand curve up or the supply curve down. For the example of the farming industry, the shift can be in both, whether the subsidy is in the form of money for increased production which will result in an increase in production of



a crop, or a tax break if one does not produce on all their land which results in a decrease in the production of a crop. The result of a subsidy is the creation of a price floor, or a minimum price the consumer can obtain the good (in this case agricultural goods). As an Austrian, one needs to understand the price floor's creation of the crop and, therefore when Congress outlines an increase, invest knowing that the crop's value will increase on the commodities exchange. If corn farmers receive a subsidy, but the next year it increases more than normal, then the Austrian should expect a major increase in the price of corn on the commodities exchange.

The latest tariff is by President Obama on the tire industry. He put into place a protective tariff on tires from China by 35 percent. The result is the lower-priced tires being bid up, loss of over 100,000 jobs in China, loss of retail, sales, manufacturing, and mechanic jobs in the US, and prices across the board increasing.<sup>19</sup> The Austrian, in the case of tariffs, will understand the loss of jobs and increase in producer goods for the good under the tariff. He will invest in the producer goods or decrease his risk by investing in another industry or corporation. Paying close attention to global and economic policy is important in dealing with tariffs and will surely make that specific industry very volatile while the legislation is going through Congress.

The latest example of a major new law that has impacted every business is Sarbanes-Oxley Act. This law effects every business, as they now need to have new internal controls and assessment of internal controls based on the magnitude of the firm being smaller or larger public companies. The extent that the law covers is enormous and therefore accountants and auditors have a larger amount of work. The result is in increase

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<sup>19</sup> Roy Littlefield. "Tire Industry Association Expresses Disappointment With President's Decision Concerning Chinese Tire Tariff." September 14, 2009. Tire Industry Association.

in the size of accounting, tax, and auditing firms. The Austrian investor should take notice of policy changes that effect many corporations and look to see who benefits, in this case being accounting, tax, and auditing firms, as those will be the firms that gain the most in corporate value and utility at the expense of the other firms. The results of large policy will always be the increase in value for some firms at the expense of others, in this case accounting, tax, and auditing firms at the expense of large corporations.

### **The Investor Who Lacks the Austrian Ideology:**

To best understand the Austrian way of investing, one must look at the opposite ideology. It is important to understand the differences of investing from a truly financial standpoint and an Austrian standpoint. The CFA and CFP approach looks to use technical, quantitative analysis, pseudoscience, charts, graphs, and computer models as their reasoning for investing. The financial standpoint looks to the CFA or the Certified Financial Analyst to search for a security estimates their future earnings and dividends to be better than the current because they differ from the average estimates of others, are viewed as being closer to the correct values than the consensus, and are not currently reflected in the security's market price but will eventually be reflected in its market price.<sup>20</sup> Therefore the idea is to find mis-priced stocks to invest in, or ones that are undervalued. A CFA also looks to estimate the future of indexes and therefore the future economy. However, they always realize that their number crunching estimates can be wrong and therefore do not guarantee their advice as far as a stock being mis-priced or an index being mis-priced. However, in looking to find mis-priced stocks and buying them,

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<sup>20</sup> William F. Sharpe and Gordon J. Alexander. "Investments." 4<sup>th</sup> edition. Page 668.

these CFA's are going to give advice to invest in them, and therefore increase the price to its should-be price. The issues with being a CFA and only looking at mis-priced stocks and indexes, and therefore basing the strategy of how to invest in the future economy, is that numbers can and will be wrong. Even CFA's admit that they can not adjust for all risk and all types of risk, they cannot consider all transaction costs and the variation of transaction costs, they can fail to consider a dividend or the right percent yield of that dividend, they fail to realize that they are using present knowledge to determine the uncertain future, and they can rely on old or misleading information based on the consensus. In building a portfolio, the investor or asset manager then heeds the advice of the CFA and invests accordingly. He looks at specific information when forming the portfolio, most importantly the portfolio's actual versus expected returns, its probability distribution to see if has a normal probability distribution, and the contribution of each security to the portfolio's expected return and share of the initial portfolio market value. In addition the investor will look at expected returns, variances, and covariances, which all need to be estimated.

There are different types of analysis, technical, quantitative, passive, and fundamental. In utilizing analysis one always needs to remember the importance of the "luck factor", that they make sure they are not equating their right investment decisions based on serious thorough analysis instead of luck or change.<sup>21</sup> Technical lacks the ability to rely on the understandings of human action to drive the fundamentals of business as it relies on the past behavior of the market or company to forecast the future. Quantitative lacks the ability to take into account the variables of change in wants and preferences as it

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<sup>21</sup> Richard Grimm. "Thymology and Security Analysis: The Development of an Austrian View of Investment." Page 4.

is solely based on mathematical equations and models. These models cannot take into account the randomness of the market as it is influenced by thousands of different factors, whether politics, war, human change, etc.<sup>22</sup> Passive analysis believes that volatile changes in the market cannot be understood. And therefore there is only a level of consistency that can be made that does not need analysis and rather looks to extensive portfolio diversification. This analysis, because it is based on buying long term and diversification, cannot work as, exemplified by the crash of the 1980s, it can take decades for one to regain their investment because it was not based on intelligence but rather diversification and a concept of constant increases. Therefore, fundamental analysis is the best way for one to utilize the numerical ideology of investing. By fundamental analysis, one looks at a corporation's profit and loss and their balance sheets. In the end of this analysis, one gains the understanding of the true underlying value and utility of the corporation. It focuses on income preservation and minimal risk by specifically looking at dividends, interest payments, working capital, and cash flows.<sup>23</sup> The result is the ability to understand the corporation's ability to grow, its value, and its utility. By fundamental analysis the investor can look at the economy as a whole and then break it down to smaller sectors, or vice versa. This ability allows the investor to utilize man's values and consumer demands in relation to the market and the corporation itself.

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<sup>22</sup> Taleb is the individual who coined the concept of "wild randomness" in *Black Swan* (2007)

<sup>23</sup> Richard Grimm. "Thymology and Security Analysis: The Development of an Austrian View of Investment." Page 18.

## **Austrian Investing:**

One of the benefits to being an Austrian investor is being able to distinguish between the price of the shares of the corporation and the value of the shares. Although this might seem small and insignificant, this can play a major role. As each individual equates a different value to a share, and therefore price to it, it is done so by subjective value. However, the ability to take this from just one individual and translate this to an entire market of individuals, or more importantly the corporation's consumers, will allow one to distinguish whether the price of the shares are equal to the value that firm has, with respect to its product. By this different, one will see whether or not the price of the shares are below or above the value of shares, with respect not just to one individual investor, but rather to an entire population of individual consumers and invest in such fashion.

As one looks to invest in a particular sector, they must compare companies. If one looks to possibly buy in the computer sector they must compare Apple, with Microsoft, Dell, HP, IBM, and others that meet the same needs in the hardware/software industry. For the Austrian, looking at corporations by means of a financial statement, analyst review, or previous corporate movements does not do. For the Austrian investor, they also look the state of wants in relationship to scarce amounts of good how the corporation, more importantly its leaders, allocate and make arrangements, how the leaders deal with income, buying activities of the firm based on the market, and the consumer satisfaction when they acquire the corporation's goods. Consumer satisfaction plays a key role, because as the boom grows, do the consumers want more, less, or the

same amount of the goods produced by the consumer.<sup>24</sup> This will either drive the corporation's value up or down with the boom based on the inferiority of the goods. The Austrian also understands the time element. The time element is the importance of when to introduce a new product to the market to reap the greatest return for the corporation and therefore the greatest value for the firm. By this element, Austrians realize the entrepreneurial aspect of the time element and also realize the importance of investing into a firm when a product being introduced based on corporate value. The Austrian also understands the importance of time in the economy.<sup>25</sup> Man only has so much time to do so much, therefore he has to act in a way to maximize his utility. He will therefore need to run a corporation in a way that will maximize utility, an Austrian needs to look to those corporations who can be most efficient and therefore maximize utility with their means. As an Austrian, he must invest in a firm that is run by others with great entrepreneurial foresight.<sup>26</sup> Management and those with entrepreneurial foresight run corporations. Management looks to maintain and move in the fashion of the competition, while those who run with entrepreneurial foresight look to the new entrepreneurial ventures that will take the firm to the next level. The Austrian recognizes the differences as they too are entrepreneurs and not just investors.

Investing in uncertainty and understanding the price relationships among the risky assets is difficult for any investor. For investing in risky uncertain times, using Austrian investing knowledge and financial reviews and analysis, lends itself into investment in

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<sup>24</sup> Oskar Morgenstern. *The Time Moment in Value Theory*. "Austrian Economics II The Interwar Period." Page 320.

<sup>25</sup> Morgenstern. Page 321.

<sup>26</sup> Morgenstern. Page 329.

many ways.<sup>27</sup> One can invest in secure, income-based ventures that bring back smaller but more secure returns. These investment ventures are your treasuries and AAA bonds that have little to no risk and are either insured by “good faith of the government” or have underlying insurance (in dealing with the AAA bonds that are not government backed, i.e. the corporate bonds). The other way is investing in underlying means of the corporation, where the investor does not purchase the security but rather the options on the security. By this they can limit their risk due to uncertainty and not being able to forecast. By purchasing securities, using Austrian knowledge and understanding the each firm they purchase, they can diversify themselves and limit their risk just like buying bonds or options. (Obviously this will not be the same level of risk as bonds.)

Commodities move with the boom and bust of the economy, which allows one to hedge against inflation. Futures allow one to move from hedging inflation to investing on how they see the market in the business cycle by looking at business cycle theory.

In looking to invest, one looks to find a corporation that makes the largest profit, to bring in a profit to the investor in the form of dividends or increase in stock price. However, the Austrian investor should look not to maximizing profit, as these firms look to the short-term. Rather, the Austrian realizes the importance of value to bring long-term profit, because there can be a larger maximization of corporate utility in the long-run than the short-term. This switch of utility maximization instead of profit maximization ensures that most of the Austrian entrepreneurial beliefs will occur. This means that by one investing in utility maximization firms, the firms are based on bringing utility and value to the firm, not profit. The result will be greater long-term gains at the expense of quick

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<sup>27</sup> J. Hirshleifer. *Investment Decision Under Uncertainty*. “Landmark Papers in Macroeconomics.” Page 155-179.

short-term gains. Those who run a firm with utility maximization can clearly be seen in the entrepreneurial forecasting category, not the management category. As these leaders run a firm based on the bringing most utility to the consumer, and will therefore forego present profit for great future gains.

**Conclusion:**

There are truly many factors that effect the investment decisions. Financial reviews, different types of analysis, balance sheets, and profit and loss should not be the only way to invest, but they should be used to help. The Austrian, although, has other tools to understand which firm to invest in, other than ones of pseudoscience and numerical equations. Man should not invest due to only his Austrian views or only analysis. Man must recognize cash flows, financial statements, a stock's alpha, and its beta. The strict numerical side of investing should be used to find the market price and value of the firm through fundamental analysis. No Austrian should invest solely on business cycle theory, interest rates, or praxeology, as they will only lead him in the right direction. Rather, fundamental analysis bridges the gap to allow the Austrian to make a more complete investment decision. Fundamental analysis is truly an Austrian concept. It looks to understand the firm, the industry, the environment, and the consumers in which it takes place and operates. It looks to understand how well those who run the firm, the entrepreneurs, execute the firm's capabilities and assets. Fundamental analysts look to the history of the firm, how consumers responded to change, to recent news and the industry to better understand how when this happens in the future the stock price will be affected. Once the analyst understands all these parts, he then forms his ideas of the future of the corporation based on his anticipation of the actions of others that are condition on the



actions of the business.<sup>28</sup> Forming ideas of the future of corporations, natural events, and human action is the thymological method that Mises looked to. By forming multiple ideas of the future, Thymology, the fundamental analyst is ready for changes in the market that are unexpected, such as war or political change, by re-assessing and revising the current outlook on the market to another idea previously outlined. The result is an investor who can change quicker than the rest of those in the market and to a better investment strategy. Mises said this in reference to using this idea as our basis for anticipation,

“For lack of any better tool, we must take recourse to Thymology if we want to anticipate other people’s future attitudes and actions. Out of our general thymological experience, acquired either directly from observing our fellow men and transacting business with them or indirectly from reading and from hearsay, as well as out of our special experience acquired in previous contacts with the individuals or groups concerned, we try to form an opinion about their future conduct. It is easy to see in what the fundamental difference consists between this kind of anticipation and that of an engineer designing the plan for the construction of a bridge.”<sup>29</sup>

Investing needs to be greatly effected by the Austrian school of thought, as seen through the CAPM being based on science, but investing on the exchanges and values of human action. The market is uncertain and forecasting future events or changes cannot be done through mathematical equations, as there is great error in standard deviation. From fundamental analysis, a financial but truly Austrian analysis system, an investor can use their Austrian beliefs of praxeology, interest rates, business cycle theory, and understanding of public policy in the market to forecast the future price of the shares and movement of the markets. They can take the knowledge of how man interacts in the market, how the cycle of boom to bust moves and what signs to look for, how changes in interest rates effect the market, and how to utilize fundamental analysis to fully understand the corporation and the economy. The Austrian invests not only using truly

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<sup>28</sup> Richard Grimm. “Thymology and Security Analysis: The Development of an Austrian View of Investment.” Page 22.

<sup>29</sup> Ludwig Von Mises. “Theory and History.” Page 313.

Austrian principles, but also fundamental analysis, which is clearly Austrian in its practices.

### **How to Allocate Investment Capital with this Understanding:**

The Austrian way of investing is truly superior to that of the CFA/CFP financial way. However, it is always important to not only know Austrian Investing principles, but also how to invest. The application of such principles is what will help others, will help those who lost so much of their portfolios in the past two years, and will help those in the future. Therefore, beyond knowing when to get in, out, know what a good corporation looks like, or understanding the Federal Reserve, one needs to know how to apply that knowledge.

The Austrian investor should look to commodities, as they will always hedge against the government coercion. Keeping a money market account and holding cash will never benefit an Austrian Investor, as they know that their fiat money is worthless. Rather they need to always be holding a commodity, specifically gold instead of a MM account, as that is the most highly traded. The Austrian should look to the politics of the world and invest in commodities and should look to futures as Austrians have the best knowledge of the commodities market, as that is directly tied to the effects of the central bank. An Austrian can look to stocks, by using fundamental analysis to find the best corporations, and invest directly or in their derivative. However, these will be harder to forecast, and the Austrian does not have as much gain on the non-Austrian investor, as both are subject to the same unknowns. The Austrian however, has greater knowledge of business cycle theory and can therefore better predict a long position. Options are a great way for the

Austrian to gain when they expect great market volatility in a certain direction. As they can use their understanding of human action, markets, and business cycles to make bigger gains on a short position of the market when the market is overvalued and everyone else thinks the market is not. (This is most true as Austrian theory shows that the S&P 500 is over valued because of money supply inflation, but it continues to increase in value and is shown as undervalued by technical analysis.)

Overall, the Austrian can use his knowledge to invest their capital in commodities or securities and their derivatives as well. However, the Austrian will realize their biggest gains in the derivatives market as they can use their ability to forecast to make bigger gains during the volatile times. During the regular boom and bust they will be able to know how and when to invest and go long or short accordingly in the commodities and stock market. Truly the Austrian has the ability to invest in a wide variety of regions, and are better off at investing than the non-Austrian.

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