Risk, Mispricing, and Value Investing

Published: December 2004

Volume 23, pages 353–376, (2004) Cite this article

Review of Quantitative Finance and Accounting

Eli Bartov[1] & Myungsun Kim[2]

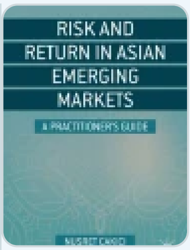
Abstract

We evaluate the stock return performance of a modified version of the book-to-market strategy and its implications for market efficiency. If the previously documented superior stock return of the book-to-market strategy represents mispricing, its performance should be improved by excluding fairly valued firms with extreme book-to-market ratios. To attain this, we classify stocks as value or glamour on book-to-market ratios and accounting accruals jointly. This joint classification is likely to exclude stocks with extreme book-to-market ratios due to mismeasured accounting book values reflecting limitations underlying the accounting system. Using both 12-month buy-and-hold returns and earnings announcement returns, our results show that this joint classification generates substantially higher portfolio returns in the post-portfolio-formation year than the book-to-market classification alone with no evidence of increased risk. In addition, this superior stock return performance is more pronounced among firms held

primarily by small (unsophisticated) investors and followed less closely by market participants (stock price <$10). Finally, and most importantly, financial analysts are overly optimistic (pessimistic) about earnings of glamour (value) stock, and for a subset of firms identified as overvalued by our strategy, the earnings announcement *raw* return, as well as abnormal return, is negative. These last results are particularly important because it is hard to envision a model consistent with rational investors holding risky stocks with predictable negative *raw* returns for a long period of time rather than holding f*T*-bills and with financial analysts systematically overestimating the earnings of these stocks while underestimating earnings of stocks that outperform the stock market.

Similar content being viewed by others

Accrual mispricing, value-at-risk, and expected stock



Book-to-Market Ratio

Connecting book rate of return to risk and return: the

References

Ali, A., L. S. Hwang and M. A. Trombley, “Arbitrage Risk and the Book-to-Market Anomaly.” *Journal of Financial Economics* (2002) (forthcoming).

Basu, S., “Investment Performance of Common Stocks in Relation to Their Price to Earnings Ratios: A Test of The Efficient Market Hypothesis.” *The Journal of Finance* 32, 663–682 (1977).

Google Scholar

Beaver, W., “The Information Content of Annual Earnings Announcements.” *Journal of Accounting Research* 6, 67–92 (1968).

Google Scholar

Brown, L. D. and M. S. Rozeff. “The Superiority of Analyst Forecasts as Measures of Expectations: Evidence from Earnings.” *The Journal of Finance* 33, 1–16 (1978).

Google Scholar

Brown, L. D., P. A. Griffin, R. L. Hagerman and M. E. Zmijewski. “Security Analyst Superiority Relative to Univariate Time Series Models in Forecasting Quarterly Earnings.” *Journal of Accounting and Economics* 9, 61–88 (1987).

Google Scholar

Chan, K., Y. Hamao and J. Lakonishok. “Fundamentals and Stock Returns in Japan.” *The Journal of Finance* 46, 1739–1764 (1991).

Google Scholar

Doukas, J. A., C. F. Kim and C. Pantzalis. “A Test of the Error-Expectations Explanation of the Value/Glamour Stock Returns Performance: Evidence from Analysts' Forecasts.” *The Journal of Finance* 57, 2143–2166 (2002).

Google Scholar

Fama, E. F. “Efficient Capital Markets: II.” *The Journal of Finance* 46, 1575–1617 (1991).

Google Scholar

Fama, E. F. and K. R. French, “The Cross-Section of Expected Stock Returns.” *The Journal of Finance* 47, 427–465 (1992).

Google Scholar

Griffin, J. and M. Lemmon. “Book-to-Market Equity, Distress Risk, and Stock Returns.” *The Journal of Finance* 57, 2317–2336 (2002).

Google Scholar

La Porta, R., J. Lakonishok, A. Shleifer and R. Vishny. “Good News for Value Stocks: Further Evidence on Market Efficiency.” *The Journal of Finance* 52, 859–874 (1997).

Google Scholar

Lakonishok, J., A. Shleifer and R. Vishny, “Contrarian Investment, Extrapolation, and Risk.” *The Journal of Finance* 49, 1541–1578 (1994).

Google Scholar

Mulford C. W. and E. E. Comiskey, *The Financial Numbers Game: Detecting*

Creative Accounting Practices. New York: John Wiley & Sons, Inc. 2002.

Google Scholar

The New York Times. Cheap Stocks: Undervalued? June 8 (1978).

O'Brien P. C. "Analysts' Forecasts as Earnings Expectations." *Journal of Accounting and Economics* 10, 53–83 (1988).

Google Scholar

Piotroski, J. D., "Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers." *Journal of Accounting Research* 38, 1–41 (2000).

Google Scholar

Rosenberg, B., K. Reid and L. Ronald, "Persuasive Evidence of Market Inefficiency." *Journal of Portfolio Management* 11, 9–17 (1985).

Google Scholar

Shumway, T., "The Delisting Return Bias in CRSP Data." *The Journal of Finance* 52, 327–340 (1997).

Google Scholar

Sloan, R. G. "Do Stock Prices Fully Reflect Information in Accruals and Cash Flows About Future Earnings?" *The Accounting Review* 71, 289–316 (1996).

Google Scholar

Vassalou, M., "Default Risk in Equity Returns." Working Paper. Columbia University (2001).

The Wall Street Journal, Leading the News: AT&TCorp. Resorts To Unusual Motion: Reverse Stock Split-Market Capitalization Stays Constant, but Measure Would Boost Share Price. April 11 (2002).

Author information

Authors and Affiliations

Leonard N. Stern School of Business, New York University, 40 W. 4th St., Suite 423, New York, NY, 10012, USA.

Eli Bartov

Department of Accounting & Law, School of Management, University of Buffalo, SUNY, Buffalo, NY, 14260, USA.

Myungsun Kim

Rights and permissions

About this article

Cite this article

Bartov, E., Kim, M. Risk, Mispricing, and Value Investing. *Review of Quantitative Finance and Accounting* **23**, 353–376 (2004). https://doi.org/10.1023/B:REQU.0000049321.34133.95

Issue Date

December 2004

DOI

https://doi.org/10.1023/B:REQU.0000049321.34133.95

book-to-market market efficiency mispricing accruals