# Risk, Mispricing, and Value Investing

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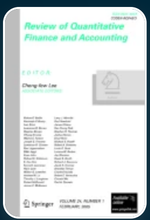

Review of Quantitative Finance and Accounting



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## 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.

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book-to-market market efficiency mispricing accruals