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Where Is the Value Premium?

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Abstract

The value premium is driven by 7 percent of the stock market. The 93 percent of market capitalization held most by institutional investors is value premium free. In contrast, in stocks held most by individual investors, the value premium, even when the stocks are value weighted, reaches a staggering 185 bps per month. In addition, the value premium is a long-side anomaly. It is a value premium puzzle, not a growth discount puzzle.

The premise of this article is that if the value premium is a result of both pricing errors and limit ... ocks that are both ... bitrage. Such a concer ... n this artic ... ee of a value ...

Using in ... by their mispricin ... es from a high 185 bps for low-IO stocks to a negligible 13 bps for high-IO stocks. This result also holds when returns are value weighted and, importantly, is driven mainly by the long side. Low-IO value stocks are those with the most abnormal returns. The anomaly is a value premium, not a growth discount, as is sometimes argued.

Another way to express this important point is that over the last 20 years (on an equally weighted basis), only 15 percent of the value premium came from the short side. Even if one could not short growth stocks, one could short the S&P 500 Index and be long on value stocks, which would have generated 85 percent of the unconstrained value premium.

The extreme concentration of the value premium has important practical implications. First, arbitrageurs can expect to face substantial costs when trying to arbitrage the value premium, and those focusing on the stocks most held by institutional investors (the larger, more liquid stocks) will have difficulties generating arbitrage profits. The value premium concentrates where arbitrageurs usually do not go. This reason is also why studies have found that value and growth mutual funds perform the same. Second, studies that select a subsample of stocks that, for instance, either have at least two to five analysts following the stocks or are traded on the NYSE end up with a sample that is almost free of the value anomaly. Such a fact is important to bear in mind when interpreting the results found in such samples.

I am grateful to Jim Davis for generously providing me with many details about the data construction. I am also thankful to Pamela Grant for authorizing me to use I/B/E/S data for the present article. In addition, I thank the many people who have given me helpful comments and the participants at numerous academic and practitioner seminars/conferences in the United States, Europe, and Asia.

Notes

[1] Koth… …hen analysis is condit… …ses. Ball, Kothari, … …en measuring returns of small-capitalization value stocks. They suggested forming

portfolios at the end of June instead of the end of December. Lo and MacKinlay (1990) and Conrad, Cooper, and Kaul (2003) warned against data snooping.

[2] For example, Fama and French (1993); Lettau and Ludvigson (2001).

[3] For example, Lakonishok, Shleifer, and Vishny (1994); Daniel and Titman (1997); Griffin and Lemmon (2002); Chan and Lakonishok (2004).

[4] Other explanations based on investors making various mistakes have also been proposed.

[5] Note the implication that individual investors are more likely than institutional investors to make mistakes but not that institutional investors will not make any mistakes.

[6] In addition, Gompers and Metrick (2001) found a strong positive relationship between IO and two proxies for liquidity (price level and turnover). On the short side, D'Avolio (2002) showed that the cost of taking a short position decreases with increasing IO. Also, indirect short positions via the use of derivative instruments are cheaper when IO is high.

[7] The website is http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html.

[8] "Price impact" estimates the impact on price of $1 million traded in a day in percentage terms. To construct it, I averaged, over a year, the (daily) ratios of the daily absolute return to the dollar trading volume (in millions) on that day.

[9] In the early 1980s, more than 10 percent of the stocks had zero IO. Hence, to form IO deciles, I excluded zero-IO observations throughout. Including them did not alter results.

[10] For th ... o in June of year t + ... BE/ME or size i ... ken into acco ... ansaction costs).

[11] Intere ... tutional ownership cannot be explained by the most prominent asset-pricing models, as shown

in Phalippou (2007). For instance, the model of Fama and French (1993) was strongly rejected by Gibbons, Ross, and Shanken's (1989) test; large pricing errors were generated. Alternative models have performed equally poorly.

[12] Including stocks with an IO reported at zero and then creating quintiles (because 20 percent of the stocks had zero IO in the first months of the sample) did not change the monotonicity and strength of the relationship. The value premium was 165 bps in the lowest IO quintile and 9 bps in the highest IO quintile.

[13] Evidence is even more striking when the value and growth portfolios of Fama and French (1993) are used. From 1963 through 2001, average return on the Fama–French portfolio of value stocks was 1.4 percent; on the Fama–French portfolio of growth stocks, 1 percent; on the S&P 500, 0.7 percent. From 1980 through 2001, average return on the Fama–French portfolio of value stocks was 1.4 percent; on the Fama–French portfolio of growth stocks, 1.1 percent; and on the S&P 500, 1 percent. Hence, an arbitrageur would have been better off shorting the S&P 500 instead of shorting the Fama–French growth stock portfolio in either time period. Because shorting the S&P 500 is cheap, short-sale constraints do not explain the value premium.

[14] The value premium in the DFA subsample is the difference in the return of the "most value" midcap stocks and "least value" midcap stocks because DFA focuses on midcap value stocks. A low value premium is thus to be expected.

[15] In results not reported here, I found that in a multiple regression, IO dominated various competing characteristics—namely, size, idiosyncratic volatility, analyst coverage, and liquidity. The reader may also consult Arnott (2005) about disentangling the size effect and BE/ME effect.

[16] In this study, data snooping would have occurred if I had looked at many characte … case of data snooping … obtains a t-statistic … 99.9 percent … the highest t-sta…