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Portfolio Management

Where Is the Value Premium?

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Abstract

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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.

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Notes

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Kothari, and Shanken (1995) stressed microstructure/liquidity problems when

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.

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[11] Interestingly, this tight relationship between the value premium and institutional 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.

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