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Fundamentals of Value versus Growth Investing and an Explanation for the Value Trap

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Notes

[1] This article draws on Penman and Reggiani (2013); Penman, Reggiani, Richardson, and Tuna (forthcoming); and Penman and Zhang (2018)—papers that connect earnings
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we eliminate companies with stock prices less than $1.00. For companies that are

delisted during the 12-month holding period, we calculated the return for the remaining months by first applying the CRSP delisting return and then reinvesting any remaining proceeds at the risk-free rate. Doing so mitigates concerns about potential survivorship bias. Companies that are delisted for poor performance (delisting codes 500 and 520–584) often have missing delisting returns. We applied delisting returns of –100% in such cases, but the results are qualitatively similar when we make no such adjustment.

[4] There are also a few loss companies in E/P Portfolio 2. Results are similar when we strictly confined all loss companies to Portfolio 1, with Portfolios 2–5 formed from ranking companies with positive E/P. The second sort on B/P is not a further sort on E/P: Calculations show that portfolio E/P is held constant across levels of B/P, except for E/P Portfolio 1 (loss companies), where E/P is actually negatively correlated with B/P.

[5] This formula is strictly correct only for full payout, because then the substitution of earnings for dividends maps directly to the no-arbitrage (constant discount rate) dividend discount model. The formula is often modified to accommodate different payout policies—with a constant payout ratio in the Gordon model, for example. But for expositional purposes, simplicity is a virtue, and under the Miller and Modigliani (1961) assumptions, payout is irrelevant: Although less than full payout increases expected earnings growth, g, it does not affect price. By excluding growth that comes only from retention (dividend payout), we focus on growth that comes from the success of investm … wth-
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[8] The focus on conservative accounting is not to deny that earnings and book values might be manipulated, as entertained in Kok, Ribando, and Sloan (2017). But the accounting principles invoked here are pervasive and dominating, subject to audit, with determining effects on earnings and book value.

[9] The effect of conservative accounting on ROE is simply due to the constriction of the accounting—the accounting principles invoked along with the debits and credits of the double-entry system. Feltham and Ohlson (1995) and Zhang (2000) demonstrated this. Penman and Zhang (2018) developed a measure of the effect of conservative accounting on ROE and documented empirically how this measure affects ROE in the way described.

[10] As a postscript, Twitter reported positive quarterly earnings for the first time in 2018, with a large jump in its share price—uncertainty (somewhat) resolved.

[11] See also Greg Bensinger, “Amazon Sales Boost Stock: Investors Focus on 24% Jump in Revenue Even as Bottom Line Remains in Red,” Wall Street Journal (25 October 2013): B3, Eastern Edition); and Barney Jopson, “Amazon Pays for Keeping Up Sales Momentum,” Financial Times (24 October 2013): 13. The Wall Street Journal also reported on a study by Citigroup that found 90% of a present value calculation on Amazon related to cash flow forecasts for 10 years in the future. See Liam Denning, “Here to Eternity for Tesla,” Wall Street Journal (25 October 2013): C1, Eastern Edition.

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growth findings here. So, we ascertained the fraction of companies that ceased to exist in the second year for performance-related reasons indicated by CRSP delisting codes. The delisting rate was higher for high-B/P companies, an average of 8.9% over all high-B/P portfolios in the first year ahead versus 7.7% for low-B/P portfolios. The corresponding delisting rates over the next two years were 20.8% and 16.9%. This result reinforces, rather than qualifies, our inferences; pertinent to the risk discussion that follows, delisted companies are those that had either low payoffs with company failure or high payoffs in being acquired; that is, they exhibit a wider spread of outcomes.

[15] So, mean ROE for the low-B/P portfolio in E/P Portfolio 3 is 24.1%, compared with 4.8% for the high-B/P portfolio, and is similar for other E/P portfolios. The exception is Portfolio 1, with negative earnings, where the low-B/P portfolio has a lower negative ROE than the (negative) ROE for the high-B/P portfolio, as is also implied by Equation 2 when earnings are negative.

[16] Because added investment from retention in the first year ahead adds to earnings growth two years ahead, we also calculated the residual earnings growth rate two years ahead to subtract for the added investment. Residual earnings were calculated as earnings with a charge against beginning-of-period book value at the prevailing yield on the 10-year US government note. Results were similar. Portfolios were formed on the basis of ... ard E/P in
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portfolio relative to price. The market earnings are total earnings for all companies relative to price.

[19] The earnings betas here are consistent with the findings of Cohen et al. (2009) and Campbell et al. (2010), who attributed the higher returns of value stocks to higher "cash flow betas"—that is, the sensitivity to news about future cash flows.

[20] A similar table (with decile portfolios) can be found in Penman et al. (forthcoming).

[21] In Table 2, B/P is positively correlated with subsequent earnings growth conditional on E/P. However, Penman et al. (forthcoming) reported that B/P is unconditionally positively correlated with subsequent earnings growth. Chen (2017) reported that low-B/P stocks do not have significantly higher dividend growth than high-B/P stocks.