

Global Equity Strategy

Improving returns using inside information

Watching what companies do rather than listening to what they say can markedly improve your returns. Net equity issuance appears to offer powerful insights for both value and growth investors. However, most investors seem to prefer to talk to management rather than observe their market actions. Tempting as these siren stories may be, investors would be better off focusing on the facts.

- ▶ Every so often I come across an academic paper that appears to be destined to become a classic. I recently stumbled over one such paper by Bali, Demirtas and Hovakimian. They combine a simple value strategy with another well-known ‘anomaly’, net equity issuance. Many studies have found that companies time their equity issuance; that is they sell shares when it is cheap for them to do so (i.e. expensive for investors), and repurchase them when valuations are cheap.
- ▶ Bali et al examine US data from 1972-2002. They find significant gains to both value and growth investors from including net equity issuance in their analysis. For instance, a simple value strategy of buying cheapest 20% of the market by P/B yields an average excess return of 2.6% p.a. over their sample. However, by concentrating on value stocks with negative net issuance (i.e. net repurchases) this rises to 5.5% p.a. If you extend the time horizon the returns continue to improve. Over four years, a simple value strategy generates an excess return of 13% on average. Using net equity issuance improves this to 24% on average.
- ▶ The usefulness of this signal is not restricted to value investors (although Bali et al don’t draw this out explicitly). Growth stocks that are net equity repurchasers do markedly better than the general growth universe. Over one year they generate an average excess return of 1.2%, whereas the growth universe underperforms the market by 1.8% in the first year.
- ▶ A hedge strategy of going long value repurchases (VP) and short growth issuers (GI) vastly improves a simple long value short growth strategy. The simple value/growth portfolio earned an average of 4% in year one, rising to 28% in year 4. However, the VP – GI strategy generated 10% in year one, rising to 47% in year four.
- ▶ Bali et al show that the risk explanations so beloved by efficient market believers simply don’t hold water. Indeed beta has the wrong sign in their analysis. The VP portfolio has the lowest beta and the highest return, whilst the GI portfolio has the highest beta and the lowest return. They also show that VP stocks witness an operating turnaround such that their earnings growth improves significantly, whilst GI stocks have great past earnings growth but lousy future earnings growth – exactly what behavioural finance would predict.
- ▶ Sebastian Lancetti and I find similar returns in Europe. Buying VP in Europe since 1995 has generated an excess return of 5% p.a. Whilst GI has underperformed the market by 5% p.a. over our sample. All of this evidence suggests that investors would be much better off paying attention to companies’ actions in the market place, instead of the listening to their siren-like stories.

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Improving returns using inside information

Before the FSA and SEC (not to mention our own supervisory analysts) start jumping up and down, turning apoplectic and foaming at their mouths I should make it clear that I am not talking about inside information in the sense of information that isn't publicly disclosed. Rather I am talking about using the financial market transactions of firms (a matter of public record) to improve returns.

I am relatively well known (perhaps even infamous) for arguing that investors waste much of their time in meeting with company managements (see *Global Equity Strategy*, 7 September 2005). I much prefer to watch what they are doing rather than listen to their all-too-pat stories. As my grandmother is fond of saying actions speak louder than words.

As regular readers know, I spend a fair amount of time trawling through academic papers in both finance and psychology. Every so often I come across a paper which strikes me as simply brilliant, perhaps even destined to become a classic. I recently had the good fortune to stumble on such a paper.

Every investor should take the time to read Bali, Demirtas and Hovakimian's¹ new paper "Corporate Financing Activities and Contrarian Investment". It is an easy read, clear, logical and well structured and applied (in short a real rarity amongst academic papers!).

The premise they have is simple. The evidence shows that value outperforms growth over the long-term (see *Global Equity Strategy*, 16 March 2005). Other studies have shown that firms that issue equity tend to underperform². Indeed those who have sat through one of my behavioural finance presentations will recall my diatribe on the evils of IPOs and my near constant bemusement that investors cue up to buy into expensive underperformers. Yet others have demonstrated that firms which repurchase equity tend to outperform the market³.

In the past I have argued that this equity issuance is a message from management. They issue equity when it is cheap for them to do so (effectively the equity is expensive to investors), and they purchase equity when it is cheap for them (i.e. the stock is undervalued by the market). Bali et al argue that by combining the usual value strategy with one that exploits the insider's views returns can be enhanced significantly.

Patience is a virtue

Sebastian Lancetti and I recently explored the potential returns to extending your time horizon as an investor (see *Global Equity Strategy*, 17 October 2006). Bali et al show a similar pattern to the one we uncovered. However, our results were for Europe, Bali et al use the US 1972-2002 suggesting our results were more than just statistical fluke. The methodology Bali et al employ is to split their universe into quintiles based on price to book⁴. The chart below shows the excess returns over the market for the two extreme PB portfolios. Once again patience appears to be a virtue for a value investor, and a disaster for growth investors.

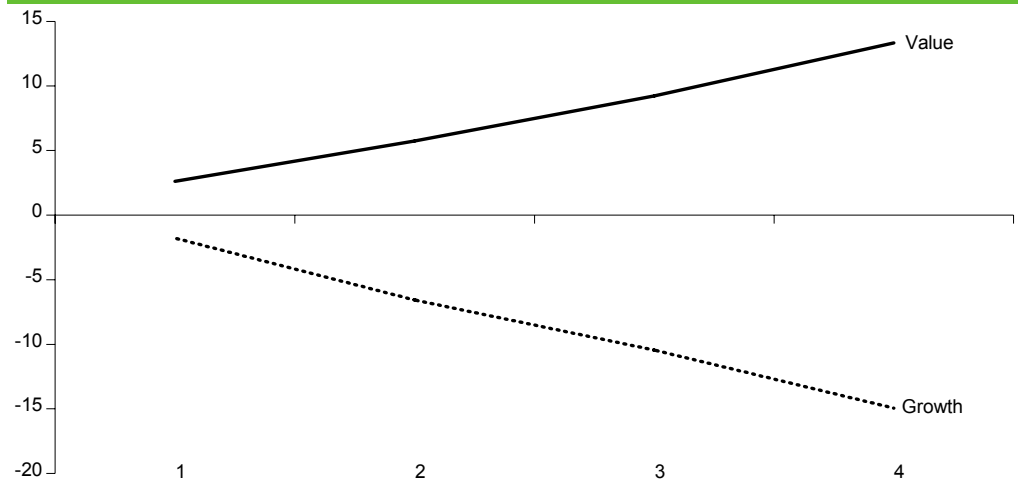
¹ Bali, Demirtas and Hovakimian (2006) Corporate Financing Activities and Contrarian Investment, available from www.ssrn.com

² For example see Jay Ritter (2006) Some factoids about the 2005 IPO Market, available from <http://bear.cba.ufl.edu/ritter/ritterwp.htm>

³ See Chan, Ikenberry and Lee (2003) Economic Sources of Gain in Stock Repurchases, available from <http://www.bschool.nus.edu/Staff/bizinmoo/JFQA2003.pdf>

⁴ They also show the results for PE and PCF as well, none are materially different from those presented here

Patience is a virtue: cumulative excess returns to a simple value strategy (%)



Source: Adapted from Bali et al

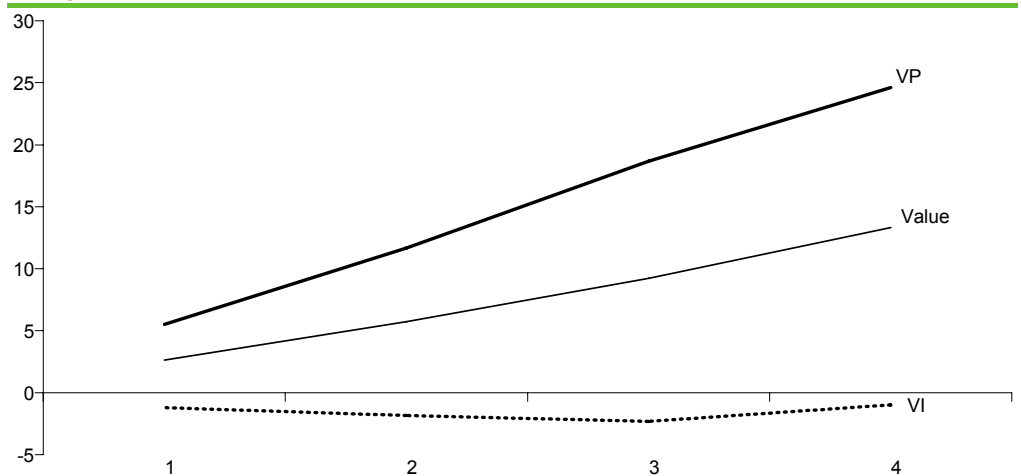
Using inside information

However, as noted above the focus of Bali et al's work is not extending time horizons. Instead they are interested in enhancing value strategies by using signals from companies' market transactions (that said, there is much in the paper relevant to growth investors, although Bali et al do not draw it out explicitly). Bali et al use last years net equity issuance divided by total assets as their proxy for management's actions. This variable avoids the problem with some of the repurchase studies which confuse net and gross buybacks by ignoring options issuance. Within each P/B quintile a binary sort is conducted with each firm either being a net issuer or net repurchaser of equity. The impact for both growth and value investors is marked.

The chart below shows the picture from a value investor's perspective. By separating out the value repurchases (VP) from the value universe excess returns over four years are raised from 13% to 24%! Even in year one there is a near doubling of the excess return from 2.6% to 5.5%.

The value issuers (VI) show a very different pattern. These stocks underperform the general market pretty much from the outset. So value investors would be well advised to avoid stocks within their universe that issue net equity, and concentrate firepower on those that repurchase.

Using inside information – the value perspective (excess returns, %)



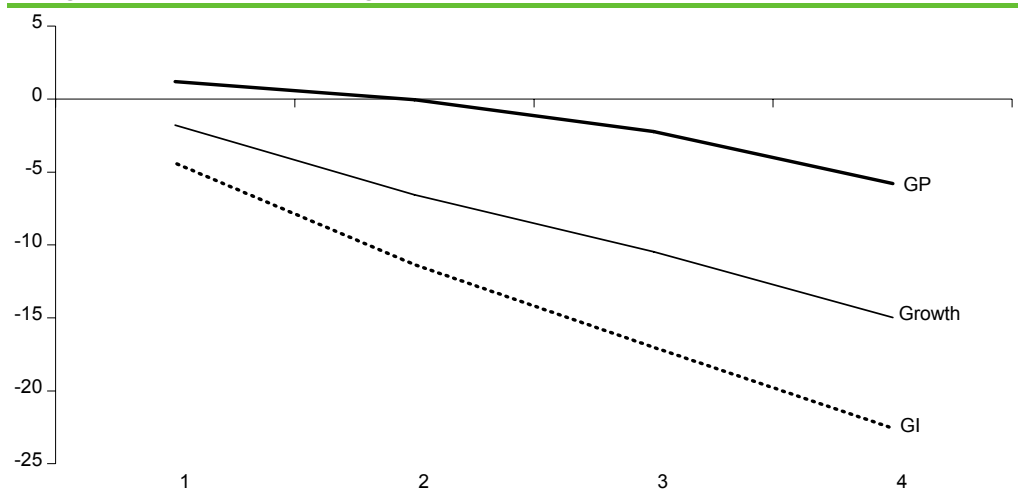
Source: Adapted from Bali et al

From a growth perspective sorting by equity issuance can also pay dividends (not sure I should use that word since it is an anathema to most growth investors). The chart below shows the picture for a growth investor.

Growth stocks that are net equity repurchasers (GP) do markedly better than the general growth universe. Over one year they generate an average excess return of 1.2%, whereas the growth universe underperforms the market by a 1.8% in the first year. Over four years, GP stocks underperform the market by nearly 6%, but growth stocks in general underperform by 15%.

Growth stocks that issue equity (GI) fare much worse than general growth stocks. They see a negative excess return of over 4% in year one, rising to -22% over four years. So both value and growth managers can seek to use equity issuance as an effective way of improving their returns.

Using inside information – the growth perspective (excess returns, %)

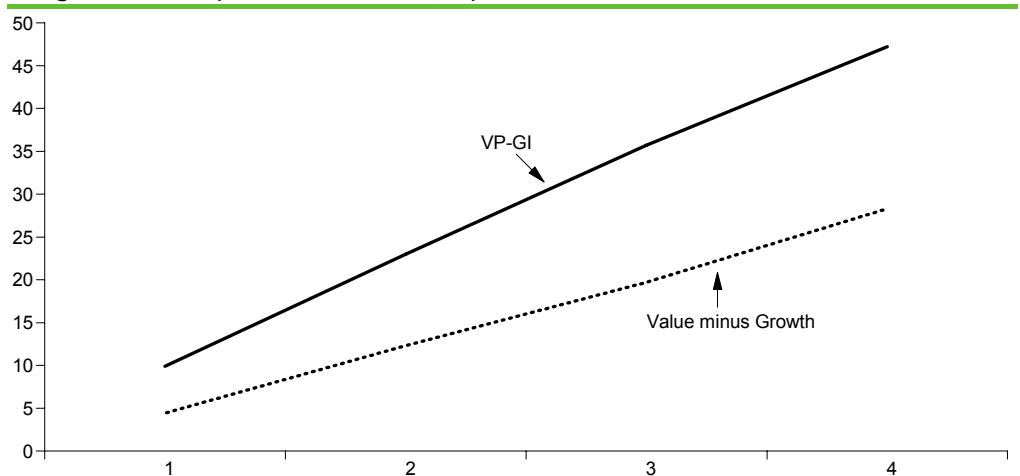


Source: Adapted from Bali et al

A hedge perspective

Of course the above analysis also suggests strategy of going long VP and short GI. The improvement this offers over time is shown in the chart below. The returns of long VP/short GI are almost twice those of simply going long value and short growth.

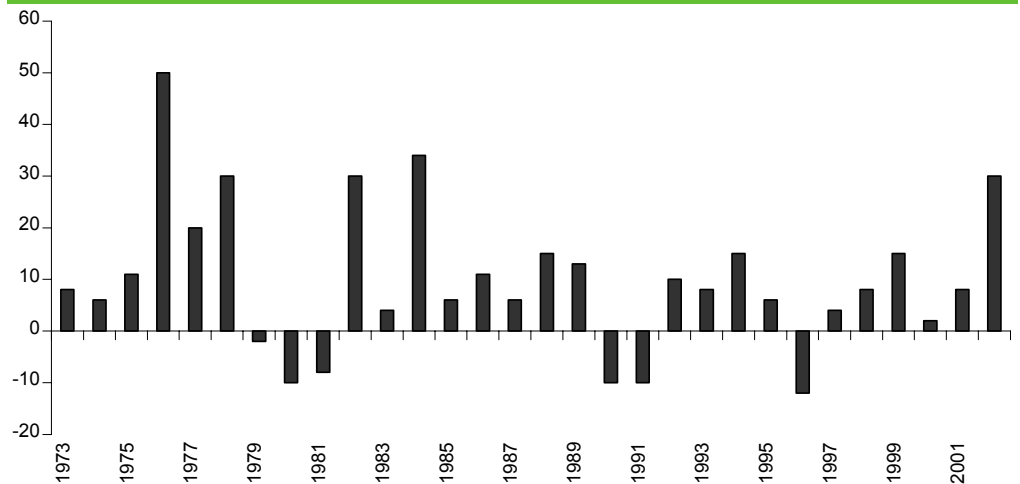
Long VP short GI (cumulative returns, %)



Source: Adapted from Bali et al

The chart below shows the year by year performance of long VP/ short GI. It does remarkably well with only six out of thirty years showing negative returns. Also notable the strategy continued to generate positive returns even during the dot.com bubble in the late 1990s.

Long VP short GI annual return performance



Source: Adapted from Bali et al

Risk or Mispricing?

There is an on-going argument between those who believe in efficient markets (EMH) (yes, they still exist and still often dominate universities, more is the pity) and those who believe in behavioural finance. The efficient market zealots would have us believe that value's outperformance is the result of their higher risk. The behaviouralists think that people tend to overestimate the growth embodied within the pricing of growth stocks, and similarly get too depressed about the outlook for value stocks.

The efficient market believers won't like Bali et al's results. Because it now behoves them to explain why it is that distress risk is much higher amongst value purchasers rather than value issuers. The only possible answer is that the value purchasers are increasing their degree of leverage and are thus more risky. However, it is hard to imagine a firm with high distress risk drawing down cash or raising debt to finance a buyback (more on this a little later).

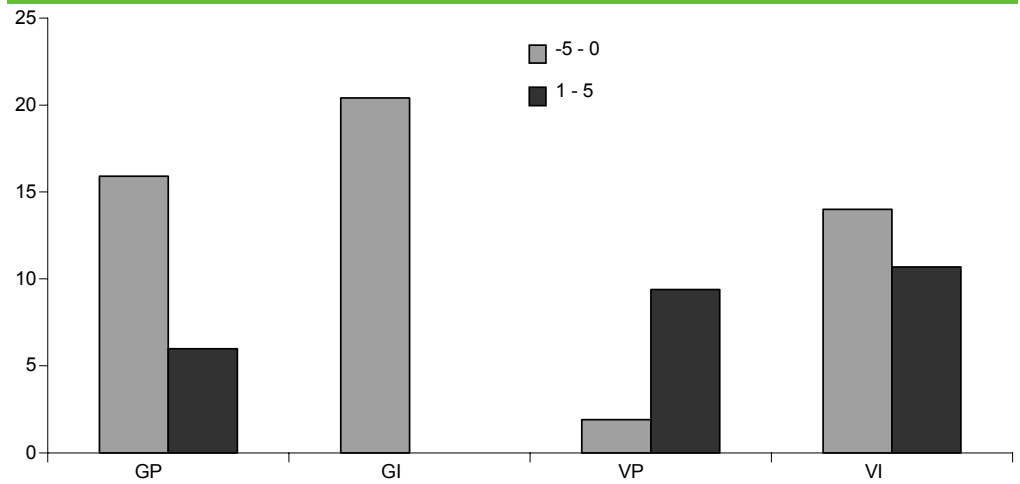
Evidence for behavioural errors

The argument from behavioural finance is that investors seem to extrapolate past earnings/cash flow growth in a simplistic fashion (representativeness). That is to say, stocks with good past earnings performance are expected to grow fast in the future, and those with poor track records are expected to do badly in the future.

The chart below shows the earnings growth rate in the five years before portfolio formation, and the growth rate in the five years after the portfolios are built. The picture certainly fits well with the behavioural story. Growth stocks (both GP and GI) have high historic growth, yet their future earnings growth is much lower. Indeed in the case of GI, the earnings growth after the formation of the portfolio is essentially zero. The GP portfolio also seems a dramatic tailing off of earnings growth but at least it still has some (around 6% p.a.). This helps to explain the underperformance of growth stocks in general and growth issuers in particular.

VP stocks have poor past performance, but the buyback seems to signal a turnaround in operating performance as earnings growth improves significantly. However, those stocks in VI show a different picture. The earnings growth slows from 14% p.a. to around 11% p.a. This helps to explain the performance of the VI stocks shown in the chart on page 3, their cheapness is offset by slowing earnings growth.

Earnings growth in the years before and after portfolio formation

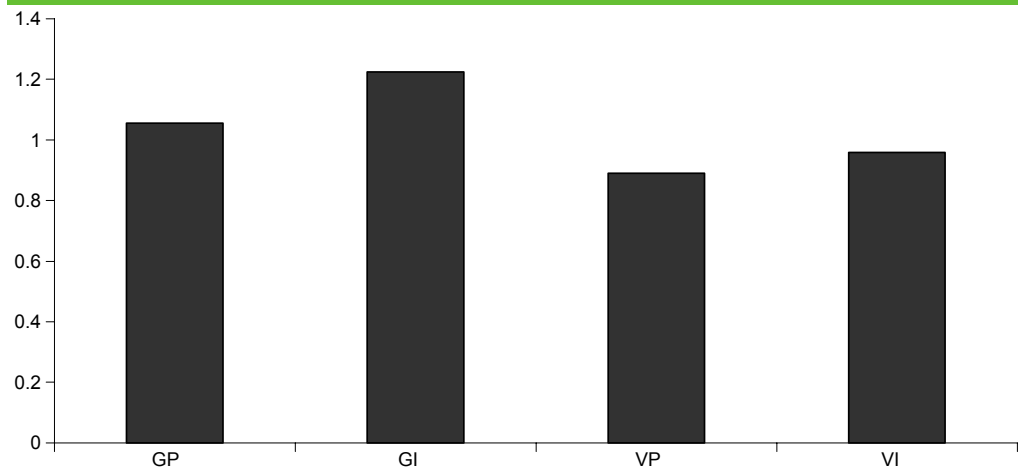


Source: Adapted from Bali et al

Evidence against the risk view

According to the believers in efficient markets, just one measure sums up the potential risk of a stock – its beta against the market. So Bali et al map out the betas across the portfolios. Their results are shown below. The findings are the inverse of those predicted by the risk based explanation so beloved by efficient marketers. Those stocks with the highest beta are the GI portfolio, which had the lowest return, whereas the stocks with the lowest beta, the stocks in the VP portfolio, had the highest return. So much for classical finance. This also suggests an important piece of advice when it comes to portfolio construction, for good long run performance buy low beta stocks⁵. The tortoise beats the hare in the end.

Average beta across portfolios



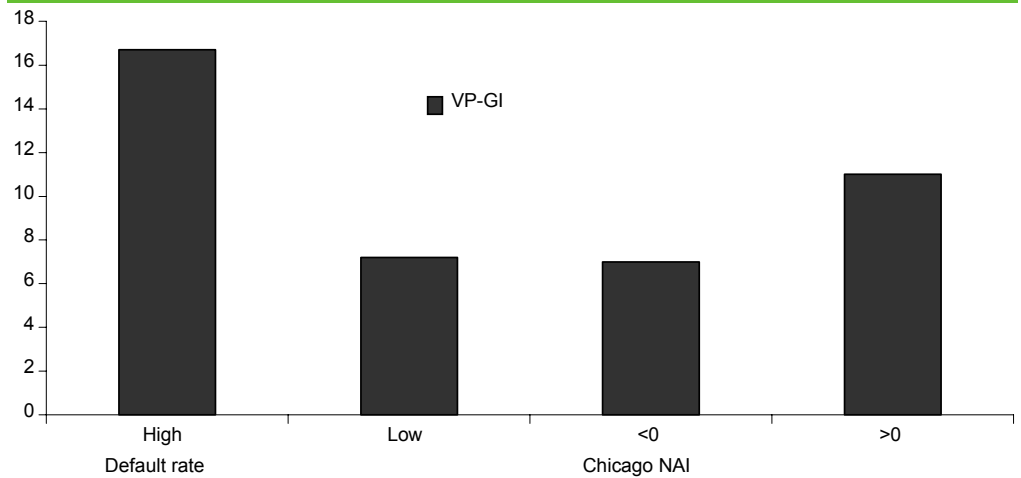
Source: Dresdner Adapted from Bali et al

Determined not to give up on their risk based solutions, the EMH supporters say that value stocks do much worse in bad states of the world. Bali use several measures to capture bad states of the world, we present just two here. Firstly, the default premium (the spread of low grade corporate debt to government paper). When the default premium is high the economy is likely to be experiencing a downturn, so value should do much worse than growth. The second proxy we present here is the Chicago National Activity Index. When this is below zero the economy is growing below trend, again implying a poor outturn for value stocks.

⁵ For more on this point interested readers should see Clarke, De Silva and Thorley (2006) Minimum-variance portfolios in the US Equity Market, Journal of Portfolio Management

The chart below shows the returns for VP-GI by states of the world. In all cases VP – GI is positive, that is to say value purchases outperform growth issuers regardless of the economic environment. This is yet another blow to the supporters of EMH.

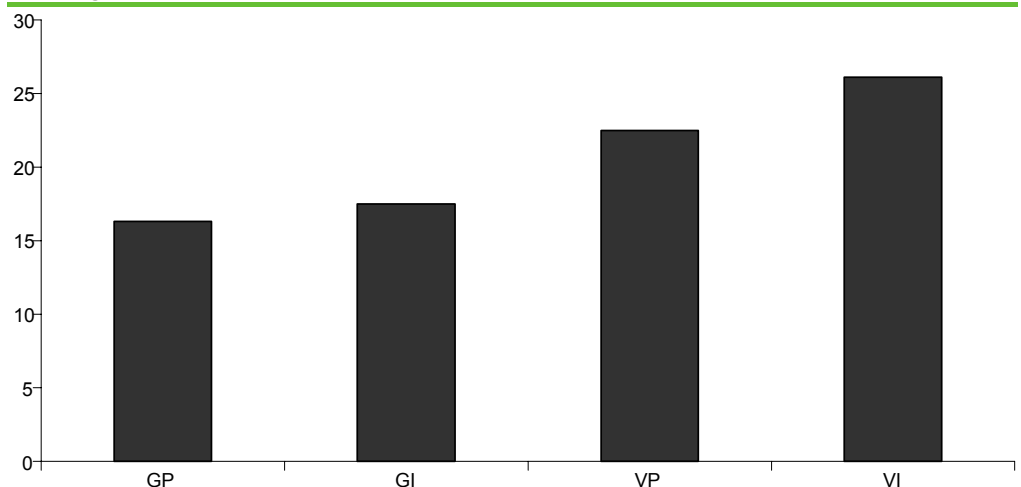
Returns in good and bad states of the world (%)



Source: Adapted from Bali et al

The final defence offered up by those desperate to cling to EMH is leverage. It has long been known that value stocks tend to have greater leverage (as measured by long-term debt to book value of assets). Bali et al show this to be case. The VP and VI have a higher leverage (22.5% and 26.1%) than their growth counterparts (GP 16.3% and GI 17.5%).

Leverage across portfolios



Source: Adapted from Bali et al

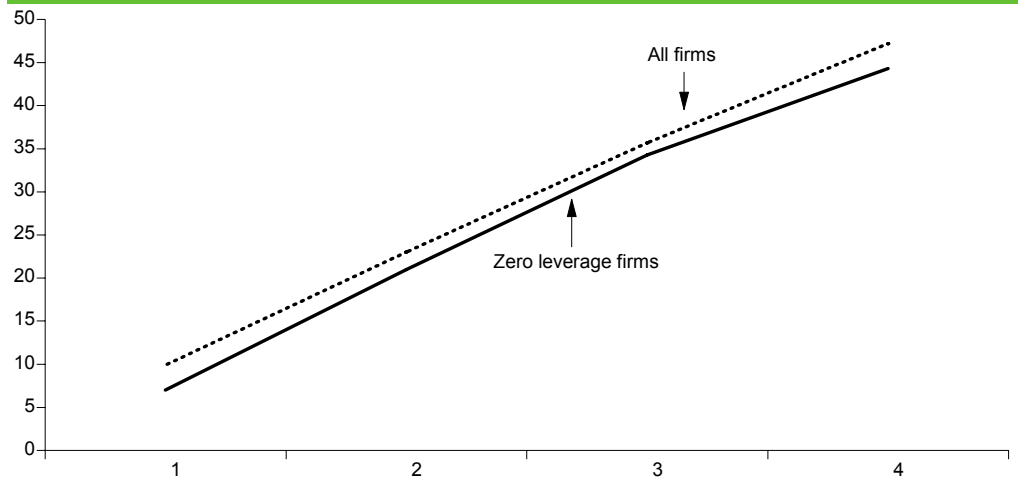
However, note that VI portfolio leverage ratio is higher than the VP leverage ratio, and the same is true in the growth universe (GI / GP). Yet it is the lower leverage portfolios that offer better returns.

Additionally, the leverage ratio is only 5 percentage points higher for the VP portfolio than the GI portfolio; whereas it is double that between the VI portfolio and GP portfolio. Yet VP-GI generates very significant outperformance, whereas the difference between VI-GP is not significant.

Both of these issues raise major problems for the leverage as risk arguments propounded by the supporters of EMH. However, Bali et al drive one final nail in the coffin for this argument by examining the performance of a sub-grouping of their sample, those firms with zero leverage. The chart below shows the zero leverage firm VP-GI against the all firm VP-GI. There is essentially no difference between these two portfolios.

All of which shows the risk arguments to be rather hollow (not that I am biased, of course!).

Zero leverage portfolio comparison

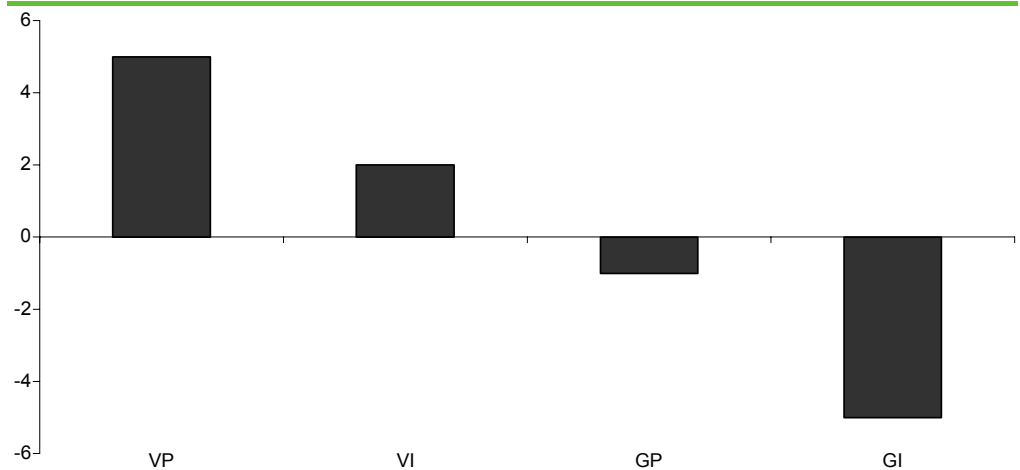


Source: Adapted from Bali et al

European evidence

Having read the Bali et al paper I was intrigued to know if similar patterns existed within Europe. So as usual I turned to our quant team for help. Sebastian Lancetti was working on his forthcoming magnum opus on earnings quality, but I managed to steal a little of his time to run the numbers for Europe. We used Worldscope data for net proceeds from equity issuance, and again used a binary sort as per Bali et al. Our data was over a much smaller sample, 1995 onwards, so we concentrated on one year ahead returns. The returns we found were still impressive. The VP portfolio earned excess returns of 5% p.a., the VI portfolio earned excess returns of 2% p.a. The GP portfolio underperformed the market by only 1% p.a., whilst the GI portfolio underperformed the market by 5% p.a.

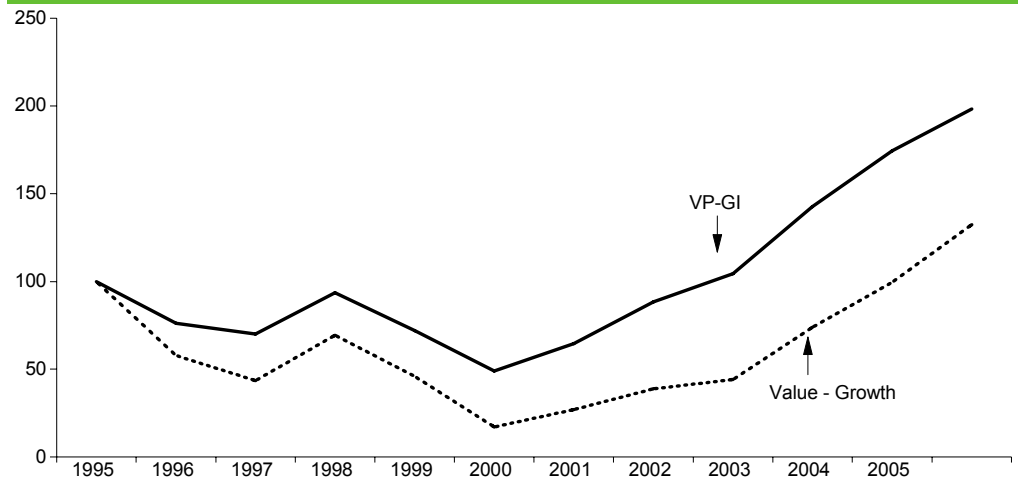
Average excess returns across European portfolios (% p.a.)



Source: Dresdner Kleinwort Macro research

A portfolio that went long VP and short GI earned a total return of 6.4% p.a. whereas a simple long value short growth earned 2.6% p.a. So like the American data, the evidence from Europe shows significant improvement in returns by using a net equity issuance filter in addition to a value screen.

Portfolio improvement by using inside information – European evidence (1995=100)



Source: Dresdner Kleinwort Macro research

Conclusions

The evidence collected here argues that the actions of corporates should be watched much more closely than their stories. Net equity issuance appears to offer powerful insights for both value and growth investors. However, most investors seem content to waste hours sitting down and talking to company managers. Perhaps it is believing the stories they are told at these meetings that leads investors to extrapolate past performance into the future. But a company’s actions in the market place seem to offer a much better guide to their future performance (both operating and financial) than the siren calls of management.

Notes

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