The Role of Expectations in Value and Glamour Stock Returns – Excerpt

The full version of this study is currently under review by editors at *The Journal of Behavioral Finance* for potential publication. Pending the editors' decision, it will be available at our website, www.brandes.com/institute, shortly thereafter.

When value and glamour stocks missed earnings expectation targets, what happened to their stock prices over the following year? While prices for glamour stocks fell as expected, prices for value stocks *went up* – even when business fundamentals deteriorated, based on results revealed in this Brandes Institute study. These findings counter assertions published by select scholars and provide fresh evidence explaining why value investing historically has been a successful long-term strategy.

The Value Premium

When attempting to explain the value premium, academics and practitioners historically have offered two competing arguments: risk and behavioral. The risk proponents suggest the excess returns represent rational compensation for the additional risk embedded in value securities. The Brandes Institute has noted in our frequent surveys of value and glamour stocks that this does not appear plausible, based on traditional measures of risk such as standard deviation. Instead, we always have contended value stocks have delivered superior returns because their purchase capitalizes on behavioral errors. In this study, we illustrate how *behavioral* biases such as overreaction, overoptimism, and anchoring contribute to the value premium.

Of the prior inquiries into an underlying cause of the value premium, we believe David Dreman and Michael Berry ("Dreman") put forth the most practical results[1]. Dreman found positive earnings surprises for U.S. value stocks resulted in larger price increases than for U.S. glamour stocks. Conversely, earnings disappointments for glamour stocks yielded greater price declines than value stocks, whose prices often rose despite an earnings setback. La Porta, Lakonishok, Shleifer, and Vishny ("LLSV") attributed value outperformance to systematically higher earnings surprises for value stocks[2].

With these findings in mind, we broadened the scope to a global universe of securities and reviewed other measures of business strength. Our findings suggest a behavioral explanation to the value premium, consistent with Dreman, but *not* as a result of systematically higher earnings surprises of value stocks as LLSV highlighted. We outline the role expectations play in investors' assessment of value and glamour stocks to better understand the sequence of events that have allowed value stocks to deliver superior long-term returns.

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[1] Dreman D., and M. Berry. "Overreaction, Underreaction, and the Low P/E Effect." *Financial Analysts Journal*, vol. 51, no. 4 (Jul.-Aug. 1995): 21-30.

[2] La Porta R., J. Lakonishok, A. Shleifer, R. Vishny. "Good News for Value Stocks: Further Evidence on Market Efficiency." *Journal of Finance*, vol. 43, no. 2 (Jun. 1997): 859-874.

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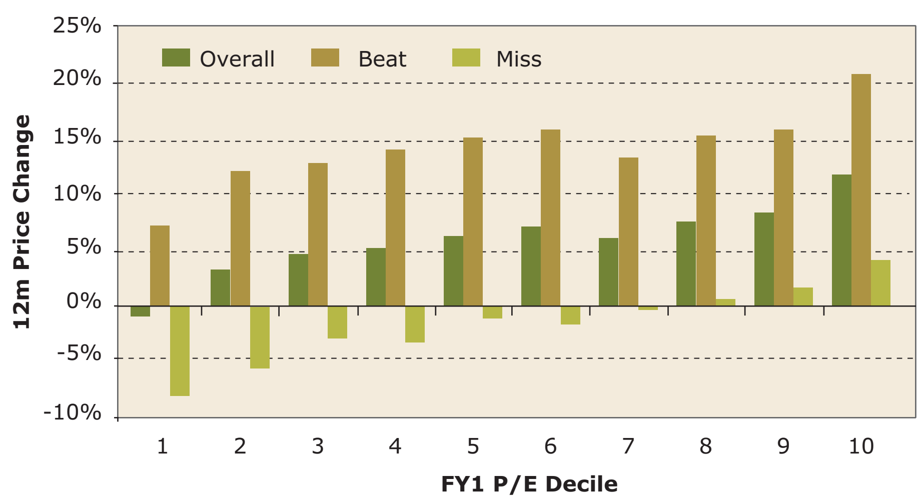
Methodology

Our study spans June 30, 1990 to June 30, 2009 and includes the largest 50% of developed market companies. This represents our global, investable universe, an approach identical to that employed in our prior value vs. glamour studies. Forward estimates of earnings represent the consensus estimate from Institutional Brokers' Estimate System ("IBES"), a proxy for investor expectations. Each June, the universe was segmented into deciles based on forward P/Es using the consensus fiscal year 1 earnings per share ("FY1 EPS") estimate. Stocks at lower deciles constituted glamour stocks (higher P/Es) while those at higher deciles represented value stocks (lower P/Es).

Results

After segmenting the universe into deciles, we tracked performance for the subsequent 12 months. As shown in Exhibit 1, prices of value stocks rose while the prices of glamour stocks fell. Most importantly, prices rose for value stocks when they exceeded (or beat) earnings forecasts *and*, perhaps counterintuitively, when they missed expectations. (Average returns for stocks beating expectations are shown in the gold bars in Exhibit 1; returns for stocks missing expectations are shown in the light green bars. We made no distinction in the magnitude of beating or missing forecasts.) Similarly, glamour stocks produced the lowest returns, whether they missed or beat expectations.

EXHIBIT 1: Average Subsequent 12-month Price Change, Beats vs. Misses, 1990-2009



Source: IBES via Thomson, as of 6/30/09. Past performance is not a guarantee of future results.

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In our opinion, these results point to the behavioral makeup of investors and illustrate why we observe an upward price trajectory for value stocks and downward trajectory for glamour stocks – independent of the performance of a company's business. Exhibit 2 shows changes in net margin and sales and subsequent returns. (For example, despite deteriorating net margins, value stocks in decile 10 delivered average 12-month returns of 7.7% the following year. Conversely, decile 1 glamour stocks with deteriorating margins fell 5.3%.) This dynamic also suggests a behavioral, and not risk-based, explanation for the value premium, seemingly driven by overreaction (value stocks) and overoptimism (glamour stocks).

EXHIBIT 2: Average Subsequent 12-month Price Change, 1990-2009

	Change from Prior Year	Glamour 1	2	3	4	5	6	7	8	9	Value 10	D10-D1 Spread
Net Margin	Improving	3.3%	7.9%	9.7%	10.3%	12.0%	11.4%	10.2%	12.6%	13.1%	16.7%	13.4%***
	Deteriorating	(5.3%)	(1.9%)	(1.0%)	(1.2%)	(0.2%)	2.3%	2.1%	2.0%	4.8%	7.7%	13.0%**
Sales	Increasing	0.6%	5.5%	6.2%	6.3%	8.3%	8.6%	7.3%	8.7%	9.6%	12.6%	12.0%***
	Decreasing	(3.2%)	(3.3%)	0.3%	0.3%	1.1%	1.9%	2.7%	3.6%	4.7%	8.4%	11.6%*
Overall 12-month Price Chg.		**(0.8%)**	**3.2%**	**4.7%**	**5.2%**	**6.3%**	**7.1%**	**6.2%**	**7.5%**	**8.5%**	**11.9%**	**12.8%*** **

* Significant at the 10% level; ** at the 5% level; *** at the 1% level.

Source: IBES via Thomson, Worldscope via Factset as of 6/30/09. Past performance is not a guarantee of future results.

Overall, our findings imply a chronology of overreaction, revision, sentiment shift, and multiple expansion in value stocks. In glamour stocks a similar record of overoptimism, revision, disappointment, and multiple *contraction* existed. Through time, the value/glamour cycle has been surprisingly persistent, perhaps because the purchase of value stocks tends to exploit, rather than succumb to, various behavioral biases. These biases tend to push prices for securities above or below their inherent worth. Over time, as the influence of these biases weakens, security prices revert away from extreme levels. As prices make this reversion, we believe there are ample opportunities for investors who can remain rational and patient.

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