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Equity financing activities and European value-growth returns

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ABSTRACT

This paper extends the U.S. evidence in Bali et al. (2010) to European stock markets. Like in the United States, European value-growth returns are strongly dependent on the valuation signals contained in the firm's equity financing activities. The high returns of value firms are due to value purchasers, while the low returns of growth firms are due to growth issuers. Among value issuers and growth purchasers, there exists no value premium at all. The large return difference between value purchasers and growth issuers cannot be explained by common risk factors. However, employing Piotroski and So's (2012) recently proposed market expectation errors approach shows that the observed value-growth returns can be attributed to mispricing.

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1. Introduction

It is well established that firms with high book-to-market ratios (value firms) are rewarded with higher average returns than firms with low book-to-market ratios (growth firms), giving rise to the so-called value premium around the world.[1] However, the source of this observable value premium remains a subject of ongoing debate. Existing research provides two alternative hypotheses that may cause the positive relation between the book-to-market ratio and subsequent stock returns, in particular, risk and mispricing.

The risk-based explanation, introduced by Fama and French (1992, 1993), argues that the value premium is a compensation for (distress) risk. Thus, value firms are rewarded with higher average returns than growth firms because they are fundamentally riskier. In accordance with this rational pricing argument, Fama and French (1995) and Penman (1996) find that high book-to-market ratios signal in general poor future earnings, while low book-to-market ratios signal in general strong future earnings.

If the return difference between value and growth firms represents a systematic risk premium, one would expect an association with other risk factors, as argued by Chui et al. (2012). Consistent with this idea, some prior works have documented that the value premium is (at least partially) related to cash flow and macroeconomic risks (e.g., Liew and Vassalou, 2000; Petkova and Zhang, 2005; Da and Warachka, 2009; Campbell et al., 2010). Thus, there is evidence that the value premium may be the outcome of risk.

On the other hand, under the mispricing-based explanation, introduced by Lakonishok et al. (1994), stocks are assumed to be overpriced or underpriced from time to time, because investors tend to underreact to changes in fundamental strength. That is, the market valuation deviates over time from the actual fundamental strength of the firm, giving rise to market expectation errors. Thus, the positive value-growth returns are the result of price corrections arising from the reversal of investors' expectation errors concerning the firm's future fundamental performance.

Supporting the notion of systematically biased investor expectations as the source of the value premium, LaPorta et al. (1997) find that value firms experience in general positive future earnings surprises, while growth firms experience in general negative future earnings surprises. In a similar vein, Piotroski and So (2012) document that positive value-growth returns are concentrated among firms, where expectations implied by the book-to-market ratio are incongruent with the actual fundamental strength of the firm, i.e., among value firms with strong fundamentals and growth firms with weak fundamentals.

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[1] See, e.g., Fama and French (1992) for U.S. evidence and Fama and French (1998, 2012), Rouwenhorst (1999), Bagella et al. (2000), and Arisoy (2010) for numerous non-U.S. evidence.

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A related literature offers evidence that a distress risk-based explanation is unlikely to account for the positive relation between the book-to-market ratio and subsequent stock returns. By explicitly controlling for distress risk among value and growth firms, Dichev (1998) and Griffin and Lemmon (2002) reject the idea that the value premium reflects distress risk, which is in sharp contrast to the rational pricing argument put forward by Fama and French (1992, 1993).

Taken together, existing literature casts serious doubt on a purely risk-based explanation for the value premium, but suggests that mispricing-related research may be a promising way to shed further light on the origins of the high returns to value firms and the low returns to growth firms. In fact, if the realization of positive value-growth returns is driven by investors' systematic misvaluation, employing an indicator variable that has been known to provide signals of undervaluation and overvaluation should help to identify ex ante mispriced value and growth firms and consequently have a major impact on the resulting value premium.

Building upon this insight, Bali et al. (2010) recently document that the U.S. value premium is strongly dependent on the valuation signals contained in the firm's equity financing activities. In particular, they find that the high returns of value firms are due to value firms that purchase their own equity, while the low returns of growth firms are due to growth firms that issue new equity. Among value issuers and growth purchasers, there exists no value premium at all.

The results of Bali et al. (2010) are interesting for two reasons. First, the value premium based on value purchasers and growth issuers is economically exceptionally large. Value purchasers outperform growth issuers on average by more than 9% per year, which is significantly larger than the standard value premium of about 5% per year based on the information contained in the book-to-market ratio alone. Thus, a value purchaser-based strategy appears to be particularly promising from an investment perspective.

Second, the opportunistic financing hypothesis suggests that firms issue equity when stock prices are high and purchase their stocks when prices are low, exploiting temporary mispricing.[2] Thus, taking into account the firm's equity financing activities should help to identify mispriced value and growth firms. Issues (purchases) provide a signal of potential overvaluation (undervaluation) based on the management's private assessment of the firm's intrinsic value relative to the market. As value issuers and growth purchasers do not produce significant return differences, the results of Bali et al. (2010) provide evidence that the value-growth returns in the U.S. stock market are attributable to mispricing.

However, as with any finding in empirical research, the uncovered interaction between value/growth and issuer/purchaser could be the result of data snooping within the meaning of Lo and MacKinlay (1990) and therefore be sample-specific. To address this concern, we contribute to the literature by independently examining in this study the relation between the value premium and the firm's equity financing activities outside the United States. In particular, we study the returns to value and growth firms in European stock markets conditional upon them being issuers or purchasers of equity. European firms provide an interesting and challenging test setting for this research question, as prior studies have shown that the European value premium is in general stronger than the U.S. value premium and significantly present among small firms as well as large firms, which are usually less prone to mispricing (Fama and French, 2012). Obtaining results similar to the previous U.S. evidence in Bali et al. (2010), would strengthen their findings and may lead to a better understanding of the value-growth effect across stock markets. In fact, if the U.S. findings of Bali et al. (2010) carry over to European stock markets, this would represent an important departure from the risk-based explanation of the value premium and resolve the two competing explanatory hypotheses in favor of mispricing in Europe.

Specifically, we test the following two hypotheses out-of-sample in European stock markets. The first hypothesis directly addresses the dependency of the value premium on the valuation signals contained in the firm's equity financing activities.

Hypothesis 1. Value purchasers significantly outperform growth issuers, but value issuers do not significantly outperform growth purchasers.

Second, as the large return difference between value purchasers and growth issuers cannot be explained by common risk factors, Bali et al. (2010) advocate in general a mispricing-based explanation for the observed value-growth returns in the U.S. stock market. Therefore, we formulate our second hypothesis as follows:

Hypothesis 2. The return difference between value purchasers and growth issuers is attributable to mispricing.

We consider three different approaches to disentangle whether the observed return behavior in European stock markets is more consistent with a risk-based or mispricing-based interpretation. In particular, we pursue explanations based on common risk factors, firm-level return predictability, and Piotroski and So's (2012) recently proposed market expectation errors approach that explicitly proxies for mispricing. Piotroski and So (2012) document for the U.S. stock market that the value premium is concentrated among firms with existent market expectation errors, i.e., among value firms with strong fundamentals and growth firms with weak fundamentals. If the outperformance of value purchasers over growth issuers is attributable to mispricing, as suggested by Bali et al. (2010), the observed return effect should consequently be derived from firms with existent market expectation errors.

Our study is in the tradition of previous works that examine whether return patterns identified in the U.S. stock market carry over to markets outside the United States for robustness concerns. For instance, Heston et al. (1995) study the size effect of Banz (1981) among European stocks, Fama and French (1998) reexamine the value-growth effect in several non-U.S. stock markets, Rouwenhorst (1998) provides evidence on Jegadeesh and Titman's (1993) momentum effect in Europe, and Dutt and Humphery-Jenner (2013) investigate the low volatility effect outside the U.S. stock market.

Our results are easily summarized. Like in the United States, European value-growth returns are strongly dependent on the valuation signals contained in the firm's equity financing activities, where issues (purchases) suggest overvaluation (undervaluation). The high returns of value firms are due to value purchasers, while the low returns of growth firms are due to growth issuers. Among value issuers and growth purchasers, there exists no value premium at all. Thus, from an investment perspective, typical value-growth strategies can be significantly enhanced by taking into account the firm's equity financing activities.

When value firms that purchase equity and growth firms that issue equity are considered, the obtained value premium is significantly magnified in comparison to standard strategies. The superior returns to value purchaser-based strategies are long-lasting, for up to four years after portfolio formation, and cannot be explained by common risk factors. However, based on Piotroski and So's (2012) recently proposed market expectation errors approach, we find that the large return difference between value purchasers and growth issuers can be attributed to mispricing. The performance is driven by de-facto undervalued value firms

[2] See, e.g., Loughran and Ritter (1995), Baker and Wurgler (2000), Bradshaw et al. (2006), Dong et al. (2012). Graham and Harvey (2001) and Brav et al. (2005) report that the mispricing aspect is one of the most important factors for the management's decision to issue new equity or purchase own equity.

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