Are hated stocks good investments?

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ABSTRACT

We study the performance of hated stocks, defined as stocks with the average analyst recommendation level of hold or worse. From 2009 to 2016, this group of hated stocks in S&P 500 performs better than the other stocks in S&P 500. When we extend the sample to all stocks with at least five analysts following, hated stocks again outperform non-hated stocks in the same time period. However, this result is driven by two factors: the impact of the time period of 2009 and 2010, and low priced stocks. If we start the strategy of investing in hated stocks at the beginning of 2011, or if we exclude low priced stocks, there is no significant outperformance of the hated stocks.

1. Introduction

Financial analysts play an important role in the capital markets. Their in-depth research can help direct the efficient allocation of market capital. In addition to earnings forecast on the companies, financial analysts typically summarize their research reports with a brief recommendation of strong buy, buy, hold, sell or strong sell. A positive recommendation such as strong buy or buy conveys the analyst's favorable view of the stock, while a negative recommendation such as hold, sell, or strong sell coveys the opposite. In general, investors react positively (negatively) to analysts' positive (negative) recommendations, see Mikhail, Walther, and Willis (2004), Loh (2010), Loh and Stulz (2011), etc. One interesting question is the long-term performance of these stocks after the analysts' recommendations.

Recently, the MarketWatch.com columnist Brett Arends suggested that the most hated stocks are good investments.[1] The idea is that a portfolio of the ten stocks that have the lowest average analyst ratings in S&P 500 outperforms S&P 500 index in 2014 and every year starting from 2008. This is a surprising result given that a number of previous studies have shown that analyst recommendations have long term investment values. In particular, Barber, Lehavy, McMichols, and Trueman (2001) show that a portfolio of highest rated stocks generates significant positive alpha and a portfolio of lowest rated stocks have significant negative alpha in the period from 1983 to 1996. This result is further confirmed by Barber, Lehavy, McNichols, and Trueman (2003), Barber, Lehavy, and Trueman (2007). Recently, Altinkilic, Hansen, and Ye (2016) show that the value of analyst recommendation is muted. They find no significant post-recommendation drift after upgrades or downgrades of stocks. However, no prior studies have used analyst recommendations as a contrarian measure, that is, low average recommendations (hated stocks) predict better performance in the future.

Our paper studies the long term performance of hated stocks as a group. We define hated stocks as stocks with average analyst

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[1] See "Easy way to get rich: Buy the most hated stocks," (http://www.marketwatch.com/story/easy-way-to-get-rich-buy-the-most-hated-stocks-2015-01-15).

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recommendation of hold or worse. This is the same definition of the worst group in Barber et al. (2001). We show that from the beginning of 2009 to the end of 2016, this group of hated stocks in S&P 500 does perform better than the other stocks in S&P 500. Digging deeper into this result, we find that the result is driven by two factors. One factor is the impact of the time period of 2009 and 2010. If we start the strategy of investing in the group of hated stocks at the beginning of 2011, we do not see a significant outperformance. The other factor is the impact of low priced stocks, stocks with a market share price below $5 per share. If we exclude these low priced stocks, there is no significant outperformance of the hated stocks starting from 2009.

We extend beyond the universe of stocks in S&P 500 and study all stocks with at least five analysts following the stocks. We exclude stocks with very low number of analysts following to avoid issues that some analysts may drop the coverage of stocks instead of giving low ratings. While we show that hated stocks appear to have better average annual performance than non-hated stocks, this result is again driven by the same two factors: a specific time period of 2009 and 2010, and low priced stocks. Excluding 2009 and 2010, or excluding low priced stocks, the outperformance of hated stocks vanishes. Given that 2009 and 2010 are two years just after the financial crisis, and investors, especially institutional investors tend to avoid low priced stocks, one should treat the result of hated stocks outperforming other stocks cautiously.

As a comparison, we also study the group of loved stocks using the same method. We define loved stocks as the stocks that have a consensus recommendation of 1.5 (the mid point between strong buy and buy) or better. As a group, loved stocks do not perform any differently compared to the non-loved stocks. Overall our results are consistent with Altinkilic et al.'s (2016) findings that there is little post recommendation drift in stocks in the current market.

Our paper contributes to the literation in two major areas. We complement the existing studies on long term performance after analyst recommendations. Barber et al. (2001) show a continued drift of the stocks in the direction of analyst recommendation in the 1990s, and Altinkilic et al. (2016) find a muted response in the period from 2003 to 2010. While the initial results on hated stocks appear to indicate that analyst recommendations become a contrarian signal in the most recent time period, a detailed analysis show that this is really driven by either the turmoil period of 2009 and 2010 or low priced stocks. For most stocks, the long-term performance after analyst recommendation remains flat. Hence, the market may overreact to analyst recommendations during 2009 and 2010 and for low priced stocks, the overall market reaction to stocks and in other time periods is still consistent with the efficient market hypothesis.

Our second contribution is a detailed analysis on the hated stocks and loved stocks. We show that sample periods and company samples can make a significant difference in the inference one can draw on certain investment strategies. Hated stocks appear to outperform the other stocks in the S&P 500 universe. However, this result depends critically on the time period and sample selection. As an investment strategy, one needs to be cautious on the conditions that it would work and the conditions that it would not work. As the hated stock result is really an indication of market overreacting to analyst recommendations, it is understandable that this overreaction tends to appear in the tumultuous two years after the financial crisis, and in the sample of low priced stocks.

The rest of the paper is organized as follows. Section 2 presents the data. Section 3 reports the results, and Section 4 concludes the paper.

2. Data

Our analyst recommendation data is from I/B/E/S and the stock return data is from CRSP. Our sample period is 2009–2016. We choose this period because Arrends showed that hated stocks performed well from 2009 to 2014, we update the time to the most recent year 2016 because this would be helpful to see whether Arrends's method is sensitive to the certain time period. In unreported results, we find that hated stocks do not outperform other stocks before this period.

We define a stock to be a hated stock when the stock has a mean recommendation level larger that or equal to 3 (hold) from I/B/E/S Recommendation Summary Statistics data. That is, a hated stock is a stock with average analyst recommendation of hold (3), sell (4) or strong sell (5). We define a stock to be a loved stock when the stock has a mean recommendation smaller or equal to 1.5 (the mid point between strong buy and buy) from I/B/E/S Recommendation Summary Statistics data. Both definitions are the same as Barber et al. (2001). We choose these definitions so that our results can be compared with those in the literature.

We study the performance at both the annual horizon and monthly horizon. The one-year holding period return of the stock is the cumulative return of the 12 monthly returns:

$$R_{iy} = \prod_{t=1}^{12} (1 + R_{it}) - 1$$

R_{it} is the stock i's monthly return, and R_{iy} is the stock i's annual return.

For portfolios, we follow a similar method. In particular, the return of the portfolio of hated stocks in year t is the cumulative return of the 12 monthly hated stock portfolio return:

$$R_{hate,t} = \prod_{i=1}^{12} (1 + R_{Xi}) - 1$$

R_{Xi} is the hated stock portfolio's monthly value weighted return:

$$R_{Xi} = \sum_{\{j \in X\}} w_{ji} r_{ji}$$

where the sum is over all j stocks in the portfolio, r_{ji} is the return of stock j in month i, and w_{ji} is the weight of stock j in month i. For a market-value weighted portfolio, the weight for stock j is the market capitalization of stock j at the end of the previous month.