An ‘Insiders’ View of Investing and the Funds Management Industry: A Summary of Some (Very) Recent Findings

Ron Bird
UTS

Paper presented at UNSW
August 31st 2000
Agenda

• Part I: Hardly academic:
  – Some observations
    • markets cannot be efficient
    • most fund managers are not trying to maximise client returns
    • in general, it is an industry where people are paid much more than they are worth
    • index funds are not all that they are cracked up to be
    • quant. versus qual. management
  – Conclusion
    • the opportunities are there for people to exploit if they go about it the right way
Agenda

• Part II: Slightly more academic
  – There are really only three games in town:
    • value
    • momentum
    • opportunistic
  – The under-reaction/over-reaction conundrum:
    • explanations
    • supporting evidence
Agenda

• Part III: Some Recent Findings
  – Global trends in earnings surprise
    • importance
    • trends
    • implications
  – Use of fundamentals to enhance value investing
    • room for enhancement
    • approach to enhancement
    • results
Market Efficiency

• Investors know very little
  – hence why they hand on every signal
• Information flows are distorted
• Who is correcting for these distortions
  – not the professionals
• End results
  – the world does not behave as economists have us believe
“The economist may attempt to ignore psychology, but it is sheer impossibility for him to ignore human nature . . . If the economist borrows his conception of man from the psychologist, his constructive work may have some chance of remaining purely economic in character. But if he does not, he will not thereby avoid psychology. Rather, he will force himself to make his own, and it will be bad psychology.”
John Keynes, “The General Theory”

“A valuation which is established as the outcome of mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which really do not make much difference . . . . since there will be no strong roots of conviction to hold it steady.”
Some Observations on Funds Management

• Managers have multiple objectives
• A strong incentive to build “comfort” in their portfolios at expense of clients
  – principal/agency relationships
• Surely this will get them fired? Not likely
• What about the longevity of the individuals
  – takes about twice a working life to determine incompetence
• Why so highly paid?
Types of Management

• Surely inefficiencies point towards active management
  – Necessary but not a sufficient condition

• Maybe index is the answer
  – Maybe not:
    • style
    • shape of return distribution
    • performance in up and down markets

• Qual. versus quant.
  – What are the differences
  – What are the pros and cons of each
  – Which is best?
A Closer Look at Quant Investing
Combining Judgement with Technology

- Philosophy
  - Proposed Mispricings
    - Research
      - Decision Rules
        - Process
          - Proposed Portfolio
            - Human Check
              - Actual Portfolio

SYSTEMATIC IDENTIFICATION

DISCIPLINED EXPLOITATION

Data

Risk and other controls
Over- and Under Reaction

• What is the evidence?
• Fama: right and wrong
• What is the explanation:
  – three papers of the late 90’s, especially Barberis et.el.
• Recent empirical work:
  – Soffer and Walther
  – Swaminathan and Lee
Behavior in Earnings Surprise: Trends and Implications

Ron Bird (UTS and GMO)
John McKinnon (GMO)

Copies of the paper are available from ron.bird@uts.edu.au
Agenda

• Why is earnings surprise important?
  – Theme one: investors know nothing
  – Theme two: earnings surprise impact on markets
• The behaviour of earnings surprise across time
• Factors contributing to any change
• Implications of any change
I: Investors know nothing

- The market perceives that there is huge asymmetry between what they and management know about a firm
- Evidenced by how the market hangs on every signal that comes from management:
  - new share issues
  - stock splits
  - capital repurchases
  - dividends
  - and yes, earnings
II: Earnings surprise

• What do we know about markets?
  – Under-reaction and over-reaction

• What causes this behaviour?
  – Barberis et al., Hong and Stein

• The role of earnings surprise
What we did?

• Studied the behaviour of earnings surprise for the following regions:
  – US (1976 to 1999)
  – UK (1987 to 1999)
  – Continental Europe (1987 to 1999)
  – Japan (1987 to 1999)
  – South East Asia (1987 to 1999)
  – Australasia (1987 to 1999)
  – Canada (1987 to 1999)
What did this involve?

• Calculating for each year the mean, median and inter-quartile ranges for earnings surprise for each region
• Determining the percentage of firms that announced earnings within a small range of the forecast for each region in each year
• Tested for any significant change/trend
• Repeated the exercise for “profit” firms and “loss” firms
What you have

• Table 1: Mean, median and range for all regions (87 to 99)
• Table 2: Mean, median and range for US (76 to 99)
• Table 3: Percentage of firms within range, positives and negatives by region by year (87 to 99)
• Table 4: Mean, median and range for all “profit” firms by region (87 to 99)
• Table 5: Mean, median and range for all “loss” firms by region (87 to 99)
Summary of Findings: US

• By far the strongest results
  – Clear trend to pessimistic bias (esp. 94 onwards)
  – Dispersion of earnings surprise has narrowed
  – Considerable increase in instances of small positive earnings surprise
  – Behaviour of mean and range much different between profit and loss firms
Summary of Findings: Japan

• Second strongest results
  – trend from pessimistic to optimistic
  – huge increase in dispersion
  – almost halving in instances of small positive earnings surprise
  – difference between “profit” and “loss” firms smaller in Japan than any other region
Summary of Findings: Australasia

• Not many significant changes:
  – move from optimism from pessimism for profit firms with no change for loss firms
  – range fairly stable at about an average level
  – no change in instances of small positive earnings surprise over entire period
Summary of Findings: Europe

• Again only minor changes:
  – clear trend from optimism to pessimism
  – range of earnings surprise has actually increased
  – decrease in instances of small positive earnings surprise
  – most optimism has and continues to come from loss firms
Summary of Findings: SE Asia

• Perhaps the third most interesting results:
  – no strong trend in direction of earnings surprise with exception of large negatives in 98 and 99
  – dispersion narrowed until 97 when it blew out
  – slight increase in instances of small positive earnings surprise until end of 97 when it dropped off dramatically
Summary of Findings: Overall

- Clear indication that major changes have been in the US and Japan
- These changes have been the exact opposite of each other
- SE Asia is another interesting result in terms of behaviour in 98 and 99
- Minor and somewhat disparate changes elsewhere
Factors Contributing to Change

• First, why optimism in the first place?
• Was this optimum policy at the time?
• What has been the change in the US?
• Who has caused the change in the US?
• Why?
• What about the rest of the world and particularly Japan and SE Asia?
• Conclusion
Are the Changes Permanent?

- Economic cycle?  
  - No
- Manager involvement  
  - Maybe
Implication of the Findings

• Explains a lot of market behaviour in recent years
• Questions whether strategies/research undertaken on old data set applies
• Highlights possible new anomalies of interest to both the researcher and the practitioner
A Fundamental Approach to Enhancing a Value Strategy

Ron Bird (UTS and GMO)
Richard Gerlach (UTS)
Using Accounting Information to Enhance Value (Piotroski)

- Value stocks are out-of-favour and/or “basket cases”
- Piotroski has identified that on average 56% of the high B/M stocks underperform
- He devised an approach using accounting data to separate out the two types of value stocks which involved grading each stocks on nine variables;
  - Profitability: ROA, CFO, change in ROA and CFO-ROA
  - Leverage: change in the use of long-term debt
  - Liquidity: change in the firms’ current ration
  - Equity: whether the firm has issued new equity
  - Operating efficiency: change in gross margin and change in the firm’s asset turnover
• Each value stock obtained a score between 0 and 9 and he came up with the following major findings:
  – He finds that Hi score (8,9) stocks outperform all Hi B/M stocks by 7+% in the first year and by 16% over two years
  – He also finds that the Hi score stocks outperform the Lo score (0,1) stocks by 23+% and 43+% over the same periods
  – Most of this advantage is attributable to stocks in the bottom two-thirds of market capitalisation but even in the large group, the scores proved a good way of separating out stocks
  – High scores seemed to be most associated with good momentum, low accruals and hi market cap (relative to low scores), and experienced much better future earnings
Bird and Gerlach

• Expanded the fundamental variables to include:
  – stock sales to market cap
  – change in assets to inventories
  – change in inventory turnover
  – change in quick ratio
  – change in capital expenditure to asset holdings
  – change in sales in inventories
  – change in ROE
Bird and Gerlach (cont.)

- Used a Bayesian approach to construct a model each year to forecast the probability of individual stock’s return would be above the average of all high B/M stocks
- Ranked and formed portfolios on the basis of these probabilities
Bird and Gerlach (cont.)

• Results
  – I did say that this was recent research