Value Stocks Are Cheap and Not Especially Risky

BUYING value stocks has been viewed as exceptionally risky by many investors and by some eminent finance professors. But a new study has concluded that these stocks are not particularly risky, suggesting that as a class, they may simply represent good value for investors.

Value stocks are cheap, at least by one popular definition, which says that their prices are low relative to their book values. Many investors have been more comfortable purchasing growth stocks, which trade at higher price-to-book-value ratios but have earnings that rise more quickly.

Why investors prefer these stocks has been a puzzle because value stocks have performed better over the long run. Two finance professors, Eugene F. Fama of the University of Chicago and Kenneth R. French of Dartmouth, report that value stocks have beaten growth stocks by 3.7 percentage points a year on average from 1927 to the end of 2002. (Some researchers suspect that the difference may be smaller than this, but none argue that growth stocks have outperformed value stocks.)

The professors subscribe to a theory that says financial markets over the long run are rational and efficient. They have argued that value stocks must be riskier than growth stocks because there would otherwise be no reason for markets to reward investors for buying them.

Disputing that theory has not been easy because it does not rely on independent evidence. Three researchers nevertheless think that they have found a novel way of refuting it. Two of them are finance professors, Alon Brav of Duke and Roni Michaely at Cornell, and the third is an accounting professor, Revene Lehavy from the University of Michigan. Their conclusions are presented in a working paper, "Expected Return and Asset Pricing," which is available online at papers.ssrn.com/sol3/papers.cfm?abstract-id=360980.

They have tried to infer stocks' risk directly from the returns investors expect to achieve when they invest in them. Because it is impossible to poll all investors, the professors focused on the expectations of research analysts. The professors found no evidence among analysts that value stocks were any riskier than were growth stocks.

The professors studied a Thomson First Call database that contained more than 7,000 yearly price forecasts made by analysts at brokerage firms from 1997 through 2001. The brokerage analysts predicted that the average growth stock would rise more than 20 percentage points a year faster than would the average value stock. To those who believe that the markets are rational and efficient, this is evidence that growth stocks are riskier than value stocks.

The professors say the prospect of investment banking business may have led the brokerage analysts to overestimate growth stocks' returns consistently. So they turned to Value Line, which does not engage in investment banking, for an unbiased sampling. They used a database containing Value Line analysts' price projections for some 2,900 stocks over the 15 years from 1987 through 2001. Among this group of analysts, there was no difference in the average expected returns of growth and value stocks.

The professors found it noteworthy that neither the Value Line nor the brokerage analysts expected that value stocks would outperform growth stocks. This suggests that neither group considered value stocks inherently riskier than growth stocks. The analysts' views are the best proxy available for investors' views, the professors said.

Based on this evidence, the professors concluded that value stocks, as a class, were no riskier than growth stocks. Bear in mind that this conclusion applies to the average value stock. Some individual value stocks will be riskier than the typical growth stock.

But this new research suggests that there is no need to avoid all value stocks out of fear that they must be riskier. They may just be bargains.