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The “value” effect and the market for Chinese stocks

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ABSTRACT

A long literature in empirical finance has isolated both a “value” and a small-capitalization effect in asset pricing. This study confirms the existence of these “style” effects both in new types of equity indexes and in the stocks of Chinese companies traded in international markets. We then present a new nonparametric method of portfolio construction that enables investors to extract the predictive power of these style effects, without diluting their efficacy through an unintended weighting distribution that closely resembles capitalization weighting. We then develop a simple method to isolate periods where style tilts are likely to be particularly effective.

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1. Introduction

A long literature in empirical finance has isolated a “value” effect in asset pricing. Studies such as [Basu \(1983\)](#) and [Keim \(1983\)](#) have shown that stocks selling at low prices relative to their earnings and book values have generated higher returns for investors. Similar results have been shown for stocks selling at low multiples to their sales. [Fama and French \(1992\)](#) confirmed a strong “value” effect in the United States stock market from the early 1960s through 1990. A particularly strong “value” effect characterized the U.S. stock market during the early 2000s as market prices adjusted from the levels that existed at the height of the “Internet Bubble.” [Fama and French \(1998\)](#) have also documented a strong “value” effect in international stock markets.

One can interpret such findings as being inconsistent with efficient markets. Portfolios made up of stocks with low market values (MV) relative to book values (BV) earn excess risk-adjusted returns when risk is measured by beta from the Capital Asset Pricing Model (CAPM). But any test of market efficiency is a joint test of the relationship of returns to MV/BVs and the efficacy of CAPM's beta to fully measure risk.

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According to Fama and French, the ratio of market value to book value itself is a risk measure, and therefore the larger returns generated by low MV/BV stocks are simply a compensation for risk. Low MV/BV stocks are often those in some financial distress.

Investigators such as Banz (1981) and Fama and French (1992) have also found a strong relationship between company size (measured by total market capitalization) and returns. Smaller firms appear to generate higher returns than larger firms. Again, the interpretation of these results is controversial. The excess returns of small firms can be interpreted as inefficiency, but they also may represent compensation for bearing risk. Smaller companies may be far more sensitive to economic shocks than are larger firms.

Some studies of the stocks of Chinese companies over limited periods of time have confirmed the existence of style effects. For example, Wong et al. (2006) found that smaller firms and “value” stocks produced excess returns in the Shanghai Stock Exchange “A” share market over the period 1993 through 2002. Similar results have been reported by Bo and Krige (2008), Drew et al. (2003), Wong and Dilorio (2007), and Lam and Spyrou (2003). But as we have shown for the United States stock market, style effects are not dependably consistent.³ Wong and Dilorio (2007) conclude that “there is no factor that has a persistent effect on stock returns.”⁴ There is also evidence that “momentum” strategies can yield excess returns in the Chinese market over the period 1995 through 2005.⁵ Brown et al. (2008) find that both “value” and “momentum” strategies produced excess returns in four Asian markets (Hong Kong, Korea, Singapore, and Taiwan). They conclude, however, that a combination of the best value and momentum strategies does not provide a significant improvement over the best value strategy evaluated separately.

2. Indexes and funds with style tilts

Many investment portfolios, whether actively managed or indexed, employ such style or factor tilts in composing their portfolios. For example, some mutual funds specialize in smaller companies, those whose market capitalizations are below the average capitalization for companies that comprise the major stock-market indexes. Other funds concentrate on so-called “value” stocks, those stocks that sell at relatively low multiples of their book values and earnings. Some indexed market mutual funds and exchange-traded funds (ETFs) are broken up into “value” and “growth” components. For example, the Standard and Poor’s 500 Stock Index has been broken up into “value” and “growth” components and investors can buy mutual fund shares and ETFs representing these components.

Considerable recent interest has been shown in a new set of indices that are weighted by certain fundamental factors such as sales, earnings, dividends, or book values, rather than by capitalization. The best known of the new “fundamentally weighted” indices that claim to improve upon cap-weighted indexes is the Research Affiliates Fundamental Index™ (“RAFI,” FTSE RAFI US 1000-Ticker PRF). The RAFI index contains 1000 stocks weighted by fundamental measures of book value, earnings, etc. It has outperformed traditional large-cap indices such as the Standard and Poor’s 500 index and the Russell 1000 index by substantial margins during the early 2000s. Such performance has emboldened the proponents of the Fundamental Index™ (FI) to claim that this new method of indexing could replace the ‘old paradigm’ of capitalization-weighted indexing. See, for example, Arnott et al. (2008).

In our judgment the reason for the ability of FI portfolios to outperform certain market benchmarks during the period from 2000 through 2005 is that FI relies in part on the “value” and “size” effects that researchers have understood for years. To the extent that earnings and book values are some of the factors used to weight stocks in the portfolio, FI will systematically overweight “value” stocks and underweight “growth” stocks. Moreover, since FI underweights stocks with high market capitalizations relative to fundamental factors, there will be a tendency for an FI portfolio to contain smaller-capitalization stocks than those in a traditional capitalization-weighted index.

Over the period from 2000 through 2005 there was a particularly strong “value” effect as well as a “small firm” effect. The bursting of the Internet bubble in early 2000 produced extremely poor returns for the overpriced large-cap growth stocks that were the market leaders during the late 1990s. FI portfolios

³ See Jun and Malkiel (2008).

⁴ See Naughton et al. (2008).

⁵ See also, Lam and Spyrou (2003).

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