Stock Return Predictability of Residual-Income-Based Valuation:

Risk or Mispricing?

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Abstract:

This paper corroborates whether the value-to-price (hereafter V/P) ratio reflects rational risk premia associated with the V/P factor, or it is rather explained by market inefficiency. Following Daniel and Titman (1997), this paper examines whether the V/P characteristics or the V/P factor loadings predicts stock returns. The findings show that the V/P loadings is positively associated with average returns even after controlling the V/P characteristic both in the time series and in the cross-sectional tests. The overall results suggest that the mispricing explanation of the V/P effect might be premature.

Keywords: Valuation, Capital Markets, Market Efficiency, Value-to-Price, Risk, Mispricing
1. Introduction

This paper corroborates whether the value-to-price (hereafter V/P) ratio reflects rational risk premia associated with the V/P factor, or it is rather explained by market inefficiency. In an influential paper, Frankel and Lee (1998) (hereafter FL) report positive abnormal returns to a trading strategy based upon the V/P. They report that positive returns to the V/P strategy cannot be explained by traditional risk factors (e.g., market beta, size and book-to-market ratio) and conclude the predictive ability of the V/P is most likely due to market mispricing.

Notwithstanding FL’s assertion on the mispricing explanation of the V/P effect, Ali, Hwang, and Trombley (2003) (hereafter AHL) find mixed results in further testing the two competing explanations. Even though they conclude that the V/P effect is due at least in part to market mispricing, they also report that the V/P is significantly related to firm-specific risk by using an extensive set of risk proxies suggested by Gebhardt et al. (2001) and Gode and Mohanram (2003), which leaves much room for future research to reexamine those two hypotheses.

Other researchers also cast doubts on the mispricing explanation proposed by FL (e.g., Lo and Lys, 2000; Kothari, 2001; Beaver, 2002). Lo and Lys (2000) argue that returns to the V/P trading strategy may be explained by the V/P ratio as a proxy for risk. Beaver (2002) notes that more research should be devoted to discriminate the mispricing and risk explanations. Kothari (2001) also raises the question why FL’s fundamental valuation strategy produces relatively small abnormal returns in the first 18 months, but large returns in the following 18 months, which suggests the need for alternative perspectives on inferences about market inefficiency, particularly in long-