



# Swedroe: Understanding The Value Premium

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The value factor clearly works, but the explanations for why vary.

Historically, value stocks have outperformed growth stocks. The evidence is persistent and pervasive, both around the globe and across asset classes. While there's no debate about the premium, there are two competing theories to explain its existence.

## **The Classic Theory**

The theory from classical financial economics is that value stocks are the equities of riskier companies. Their prices co-move with some risk factor, be it distress, liquidity or the “black swan” risk of an extremely negative economic event.

Finance professors Eugene Fama and Kenneth French constructed a proxy for this risk factor. Their HmL (high minus low) factor (the return of stocks with high book-to-market values minus the return of stocks with low book-to-market values) can be used to assess a stock's sensitivity to this yet-to-be-identified source of risk in the

economy. Value stocks have high HmL loadings and, therefore, are expected to deliver high average returns as risk compensation.

### **Behavioralists Differ**

On the other hand, behavioralists believe the premium results from pricing mistakes in the market. They argue that investors persistently overprice growth stocks and underprice value stocks. Behavioralists point out that while it may be true some risk factors are priced, the return premiums associated with these factor portfolios are simply too large, and their covariance with macroeconomic factors too low, to be considered compensation for systematic risk.

The debate between these competing explanations is important in determining whether the value premium is indeed compensation for risk, in which case, a risk-averse investor might then wish to avoid incremental risks, or a “free lunch,” in which case, all investors would benefit from exposure to it.

A recently published paper provides support for the risk-based explanation. But before we review its findings, we’ll take a look at the findings of a related study.

### **Recent Scholarship**

Lu Zhang—author of the study “The Value Premium,” which was published in the February 2005 issue of *The Journal of Finance*—concluded that the value premium could be explained by the asymmetric risk of value stocks.

Value stocks are much riskier in bad economic times and only moderately less risky in good times. Zhang explains that the asymmetric risk of value companies exists because value stocks are typically firms with unproductive capital. Asymmetric risk is important because:

- Investment is irreversible—once production capacity is put in place, it is hard to reduce—and value companies carry more nonproductive capacity than growth companies.

- In periods of low economic activity, companies with nonproductive capacity (value companies) suffer greater negative volatility in earnings because the burden of that nonproductive capacity increases and they find it more difficult to adjust capacity than growth companies.
- In periods of high economic activity, the previously nonproductive assets of value companies become productive, while growth companies find it harder to increase capacity.
- In good times, capital stock is easily expanded. In bad times, adjusting the level of capital is a difficult task, and is especially so for value companies.

When these facts are combined with a high aversion to risk on the part of investors (especially when that risk can be expected to show up when the employment prospects of such investors are more likely to be in jeopardy), the result is a large and persistent value premium.

### **More Scholarship**

Evidence supporting Zhang's findings is provided by Hernan Ortiz-Molina and Gordon M. Phillips, authors of the study "[Real Asset Illiquidity and the Cost of Capital](#)," published in the April 2014 issue of the *Journal of Financial and Quantitative Analysis*. The study covered 6,260 firms, in 304 industries, operating during the period from 1984 through 2006. Following is a summary of their findings:

- Sales of real assets in illiquid markets fetch large price discounts relative to their fundamental values, which increases firms' cost of unwinding their capital stock and reduces their ability to raise cash with asset sales. Thus, real asset illiquidity reduces firms' operating flexibility, and is an economically important source of equity risk. It has an economically significant impact on a firm's cost of capital.
- Real asset illiquidity is especially harmful in bad times, when firms are under pressure to restructure their operations and maneuver to avoid default. In

particular, real asset illiquidity can induce firms facing economic adversity to remain burdened with unproductive assets that often generate large fixed costs. The resulting operating leverage increases the covariance of a company's performance with macroeconomic conditions, especially during downturns. This in turn leads to a higher cost of capital.

- Firms with more illiquid real assets have a higher cost of capital than firms with less illiquid real assets, and firms' cost of capital is higher during periods of high real asset illiquidity.
- Illiquidity is more costly for the smallest industry competitors, which are less able to endure economic hardship and are often exposed to competitive threats from larger companies. However, illiquidity has almost no effect on the cost of capital for industry leaders (which tend to be larger firms with more sources of capital).
- Real asset illiquidity is more costly in more competitive industries, as well as for firms with less access to external capital and for firms that are closer to financial distress, because such firms may be forced to raise cash with asset sales.
- For each of the various measures of real asset illiquidity, there's a monotonically increasing pattern in the cost of capital moving across quintiles. This relation is both economically and statistically significant. For example, when using equal-weighted portfolios, the spread in the cost of capital ranged between about 4 and 5 percent depending on the measure of illiquidity.
- All measures of real asset illiquidity have a larger positive effect on the cost of capital for firms with high book-to-market (BtM) (value companies) than they do for firms with low BtMs (growth companies).

## **Takeaways**

The bottom line is that there's a strongly countercyclical real-asset illiquidity premium, meaning the premium is smaller when economic conditions are stronger. In other words, real asset illiquidity increases firms' cost of capital by decreasing their

operating flexibility.

These findings are consistent with the prior literature on the value premium, which demonstrates that value companies tend to have more irreversible capital, are more likely to be firms in distress, have risks that tend to appear in bad economic times and possess fewer alternatives for raising capital.

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