Hidden Investment Opportunities

Alex Edmans
Mercers School Memorial Professor of Business
Gresham College

October 2020


PLJ
015
AF

Introduction

- Stock market is driven by psychology, not just fundamentals
  - Sometimes overreacts, sometimes underreacts
  - Which is it?
- Surprisingly, overreaction and underreaction have a common source: overreaction is often due to underreaction
  - Overweight *salient* information even if it's contradicted by simultaneous *non-salient* information

The Accrual Anomaly

- Accrual: A lawyer does 1 hour of work for £200, but won’t bill until 50 hours
  - Cash flow = 0
  - Profit > 0 because she’s “earned” money, but less than £200 since client may not pay full bill
- Depreciation: A taxi company earns £5,000, using a taxi it bought last year for £10,000
  - Cash flow = £5,000
  - Profit < £5,000 due to depreciation of the taxi
- Profits = Cash Flow + Accruals (incl. Depreciation)
  - “Cash is king”
  - Accruals can be valid adjustments to profit, but also can be manipulated (e.g. to hit a profit target)

The Accrual Anomaly[1]

- Firms with high (low) accruals experience negative (positive) future stock returns
  - Particularly around future earnings announcements
- Interpretation: market underreacts to accruals, as they're non-salient
- Implication: market overreacts to profits

1. Sloan (1996)

Artificial Earnings

- Lecture 1: stock price rises if earnings beat forecasts
  - But what if market fixates on *whether* you beat the forecast, not *how*?
- "False Beaters": firms that just beat forecasts due to high accruals, low R&D, or low advertising
- "Honest Missers": firms that just missed forecasts due to low accruals, high R&D, or high advertising
- False Beaters outperformed Honest Missers by 2-4% in the short-term
  - But underperformed by 15-41% over the next three years
- Interpretation: market overreacts to earnings, underreacts to how they're achieved

Non-Salient Information

- What other non-salient information might the market ignore?
  - Signals of CEOs’ private information
  - Intangible assets

I: Signals of CEOs’ Private Information

Annual General Meetings

- Elect board, vote on other important corporate decisions
- Open question time

Management's Ideal AGM

But Not All AGMs Are Ideal

Don Thompson and the 9-Year -Old Girl

It would be nice if you stopped trying to trick kids into wanting to eat your food all the time.

How To Avoid Difficult Questions?

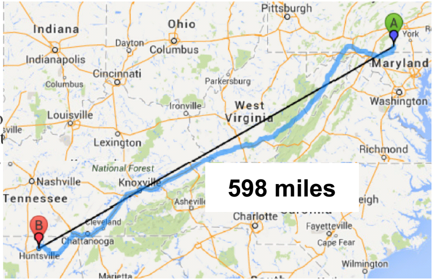
Lockheed Martin Corporation
6801 Rockledge Drive Bethesda MD 20817

LOCKHEED MARTIN

March 8, 2013

Dear Fellow Stockholders:

On behalf of the Board of Directors, we would like to invite you to
meet on Thursday, April 25, 2013, at 10:30 a.m. Central Daylight
4800 Bradford Drive, Building 406, Huntsville, Alabama 35807.
Directors and senior management at a reception at 10:00 a.m.



Remote Meetings
TRW Automotive, 2007

Exceptional Meetings
KeyCorp, 2006

- 2003 Cleveland
- 2004 Cleveland
- 2005 Cleveland
- **2006 Portland, Maine**
- 2007 Cleveland
- 2008 Cleveland
- 2009 Cleveland
- 2010 Cleveland
- 2011 Cleveland
- 2012 Cleveland
- 2013 Cleveland

KeyCorp

6m Stock Returns to Evasive Shareholder Meetings[1]

- Exceptional meetings: -11.7%
- Remote meetings: -6.8%
- 1,000 miles from headquarters: -3.7%
- 1,000 miles from major airport: -2.0%

- Average return to earnings announcement: 0.41%
- But if exceptional meeting: -2.24%

1. Li and Yermack (2017)

Quarterly Earnings Calls

- Open question time
  - But firms can choose who to call on
- Firm that call on optimistic analysts beat those that call on bearish analysts by 1.5%/month (18%/year)[1]
  - Also suffer negative future earnings surprises, more future earnings restatements

1. Cohen, Lou, and Malloy (2020)

Quarterly Earnings Calls (cont'd)

- Concern: only optimistic analysts want to ask questions; no strategic choice by firms
  - Focus on calls with phrases such as "there are no more question in the queue" at end of transcript. No possibility for strategic behaviour
    - No negative returns in these cases
  - Firms are more likely to call on optimistic analysts if
    - High accruals
    - Just met earnings forecast or beat by 1 cent
    - About to issue equity or sell own shares

1. Cohen, Lou, and Malloy (2020)

CEOs' Own Trades

- Mimicking CEOs' trades earns modestly positive returns
  - Some trades aren't driven by insider information (e.g. sales for liquidity reasons, buys after a bonus)
- Mimicking *routine* traders (who trade in the same month each year) earns -2.4%/year[1]
- Mimicking *opportunistic* traders earns 9.8%/year

1. Cohen, Malloy, and Pomorski (2012)

II: Intangible Assets

Investment

- Companies with high R&D / market value outperform those with low by 6.1%/year[1]
- Not all firms do R&D well. Some over-spend
  - But performance of past R&D is measurable (link past R&D with subsequent sales) and persistent
- Buy high-R&D firms that invest well; sell high-R&D firms that invest poorly – earns 11%/year[2]
  - Interpretation: market focuses on salient information (R&D spending), ignores non-salient information (success of R&D spending)

1. Chan, Lakonishok, and Soigiannis (2001)
2. Cohen, Diether, and Malloy (2013)

Corporate Governance

- 24 governance provisions from Investor Responsibility Research Center:
  - E.g. staggered board, golden parachute, poison pill
- Well-governed firms beat poorly-governed firms by 8.5%/year over 1990-1998[1]
  - Only in non-competitive industries[2]

1. Gompers, Ishii, and Metrick (2003)
2. Giroud and Mueller (2011)


comlux

Corporate Jets

- Sometimes a sign of corporate excess
  - RJR Nabisco: 10 private jets and 36 pilots
  - Housed in hangar containing $600,000 of furniture and containing $250,000 of landscaping
  - Flew CEO to golf tournaments, as well as passenger G. Shepherd
- But could be an investment
- Firms with corporate jets underperform by 4%/year[1]

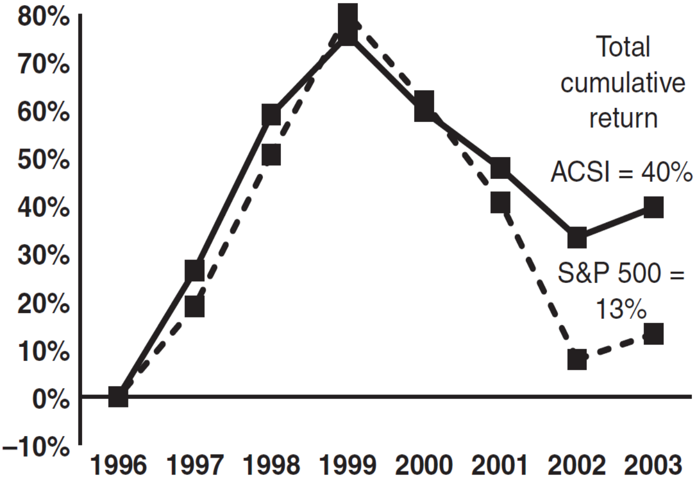
1. Yermack (2006)


THE 100 BEST
COMPANIES TO WORK FOR
FORTUNE
GOOGLITES
Yes, the employees really are this happy.
GOOGLE

Employee Satisfaction

- Best Companies to Work For outperform by 2.3-3.8%/year over 1984-2011 (89-184% compounded)[1]
  - Static 1984 list still beat the market (although by less)
  - Dropped companies outperform in some specifications
- Positive earnings surprises, particularly for long-term earnings
- Outperformance only disappears after 4-5 years
- Salient but intangible
  - Harder to assess
  - Harder to process

1. Edmans (2011, 2012)

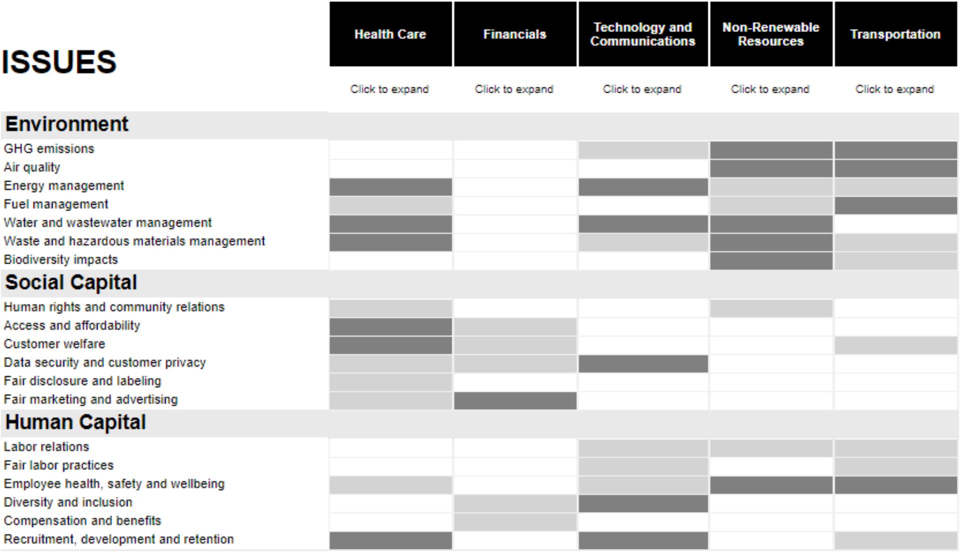


Fornell, Mithas, Morgeson, and Krishnan (2006)

Portfolio	α
High-ranked companies	
(full period)	3.98%*
	(1.93)
Low-ranked companies	
(full period)	–1.08
	(–0.55)
Difference portfolio	
Full period	5.06*
	(1.86)

Derwall, Guenster, Bauer, and Koedijk (2005)

Innovest
Strategic Value Advisors



Sustainability Accounting Standards Board Materiality Map

Material Stakeholder Performance

- ESG data from KLD (now MSCI ESG)[1]
- Firms that score high on all issues outperform by 1.5%/year, insignificant
- Firms that score high on material issues and low on immaterial issues outperform by 4.83%/year

1. Khan, Serafeim, and Yoon (2016)

Further Reading

- Grow the Pie: How Great Companies Deliver Both Purpose and Profit