Stocks of bad companies often outperform those of good ones

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Reputable companies aren't always the best investments, says a University of Michigan business researcher.

According to a study by Deniz Anginer, a doctoral student in finance at Michigan's Ross School of Business, stocks of admired companies have lower returns, on average, than stocks of despised companies over the past quarter century.

Anginer and colleagues Meir Statman of Santa Clara University and Kenneth Fisher of Fisher Investments Inc. found that during that time, the mean annualized return of portfolios of despised companies was 17.5 percent—nearly two percentage points higher than the portfolios of admired companies. Adjusting for differences favoring companies in higher-scoring industries, the margin is even greater (about 2.5 percentage points).

"We admire a stock or despise it when we hear its name, whether Google or General Motors, before we think about its price-to-earnings ratio or the growth of its company's sales," Anginer said. "Stocks, like houses, cars, watches and most other products, exude affect, good or bad, beautiful or ugly, admired or despised.

"Investors, however, who were attracted by affect to stocks of admired companies paid for it with lower returns."

The researchers analyzed the stock performance of the 611 companies

listed in Fortune magazine's Most Admired Companies from 1983 to 2006. Firms in the top half of the list comprised the admired portfolio (stocks with the highest Fortune scores) and those in the bottom half made up the despised portfolio.

Not only did the bottom half of firms have higher returns than the top half over the period examined, but the returns of the bottom 10 percent (most despised) beat the top 10 percent (most admired) by four percentage points.

Anginer and colleagues say that investors associate a company's quality—perceived or otherwise—with the investment value of its stock, and that investors with positive feelings about a firm may be willing to pay higher prices for its stock, resulting in higher valuations. Further, admired firms tend to have larger market capitalizations.

And savvy investors know that in the long run, putting money in smaller, despised stocks with lower valuations is often better than investing in big, highly valued ones.

"The results are puzzling," Anginer said. "Stocks rated highly on investment value are stocks of large-cap growth companies. Why are such stocks rated highly when the evidence on long-term stock returns indicates that they lag small-cap value stocks?"

While prior research has shown that typical Fortune respondents know how to select winning stocks by obtaining private information from industry insiders, Anginer and colleagues came up with another explanation.

"Our results are inconsistent with the private information hypothesis," Anginer said. "Rather, the typical Fortune respondents are 'noise' traders who believe, wrongly, that good stocks are stocks of good companies."

The researchers caution, however, that over certain time periods, admired companies have performed better than despised firms, and that relative returns from each may vary considerably from year to year or even decade to decade.

Source: University of Michigan

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