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Stocks of Admired Companies and Spurned Ones

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Abstract

Do stocks of admired companies yield admirable returns? Are increases in admiration followed by high stock returns? And how reliable is the relation between admiration and returns? These are the questions we answer in this paper. We study Fortune magazine's annual list of "America's Most Admired Companies" and find that stocks of admired companies had lower returns, on average, than stocks of spurned companies from April 1983 through December 2007. Moreover, we find that increases in admiration were followed, on average, by lower returns. We also find that the dispersion of returns is high, especially in the spurned portfolio. This implies that investors who want to benefit from the return advantage of spurned stocks must diversify widely among them.

Stocks of admired companies and spurned ones

Past studies on the relation between reputation and subsequent returns reached inconsistent conclusions. Clayman (1987, 1994) conducted two studies of the returns of stocks of companies labeled excellent in Peters and Waterman's "In Search of Excellence" (1982). In the first she found that stocks of excellent companies had relatively low subsequent returns but in the second she found that they had relatively high returns. Anderson and Smith (2006) and Antunovich, Laster and Mitnick (2000) found that stocks of companies ranked high by Fortune had higher subsequent returns than stocks that ranked low. But Shefrin and Statman (2003) and Statman, Fisher and Anginer (2008) found that they did not. The latter two studies focused on the perceptions of Fortune respondents rather than on opportunities available to investors, so returns were measured from the time surveys were conducted, rather than from the time they were published. In this study we focus on returns available to investors who find the ratings of companies when they are published in Fortune, months after the surveys were conducted.

We study Fortune surveys published during 1983-2007 and returns through December 2007, a period longer than in earlier studies. We find that stocks of spurned companies, namely those with relatively low Fortune ratings, beat stocks of admired companies, namely those with relatively high ratings. Further, we find that increases in ratings from one year to the next were followed by relatively low subsequent returns. The higher returns of stocks of spurned companies are statistically significant in the CAPM equation but not in the four-factor model and we discuss that relation between Fortune ratings and the factors of beta, book-to-price ratios, market capitalization, and momentum. We also find that the dispersion of returns among stocks was high, especially

among stocks of spurned companies. This implies that investors who hope to capitalize on possibly better performance of stocks of spurned companies must diversify widely among them.

Fortune surveys

Fortune has been publishing the results of annual surveys of company reputations since 1983 and the survey published in March 2007 included 587 companies in 62 industries. Fortune asked more than 3,000 senior executives, directors and securities analysts to rate the ten largest companies in their own industries on eight attributes of reputation, using a scale of zero (poor) to ten (excellent): quality of management; quality of products or services; innovativeness; long-term investment value; financial soundness; ability to attract, develop, and keep talented people; responsibility to the community and the environment; and wise use of corporate assets. The rating of a company is the mean rating on the eight attributes. The list of admired companies in the 2007 survey includes Walt Disney, UPS and Google, with ratings of 8.44, 8.37 and 8.07. The list of spurned companies includes Jet Blue, Bridgestone and Stanley Works, with ratings of 5.25, 5.34 and 5.37.

The mean rating of companies in some industries, such as the 6.53 of the Communications industry, are higher on average than those of other industries, such as the 5.26 of the Agricultural Production industry. Our focus is on companies and we distinguish company effects from industry effect by using industry adjusted ratings of companies. They are the difference between the rating of a company and the mean rating of companies in its industry.

Returns of spurned and admired portfolios

Consider two portfolios constructed by Fortune ratings; each consisting of one half of the Fortune stocks. The admired portfolio contains the stocks with the highest Fortune ratings and the spurned portfolio contains the stocks with the lowest. We construct the portfolios on April 1st of 1983, based on the Fortune survey published earlier that year¹. We calculate the returns of the portfolios during the 12 months from April 1st 1983 to March 31st 1984 from daily returns. We reconstruct each portfolio on April 1st of subsequent years based on the Fortune survey published earlier that year and calculate returns similarly during the following 12 months.

The spurned portfolio beat the admired portfolio. Table 1a shows that the mean annualized equally-weighted return of the spurned portfolio from April 1983 through December 2007 was 18.34%, beating the 16.27% return of the Admired portfolio by 2.07 percentage points. The corresponding numbers for the value-weighted portfolios are 16.12%, 13.81%, and 2.31 percentage points.

Next, consider a long-short portfolio composed of a long position in the spurned portfolio and a short position in the admired portfolio. Table 1b shows that the annualized CAPM-alpha of the long-short portfolio is 2.05% when weights are equal within the spurned portfolio and within the admired portfolio, and Table 1c shows that the annualized CAPM-alpha of the long-short portfolio is 2.56% when weights are by market value. Both alphas are statistically significant. Tables 1b and 1c also show that the annualized four-factor alpha of the long-short portfolio is 0.82% when weights are equal and a negative 0.25% when weights are by market value. Neither is statistically

¹ Surveys were published in January during 1983-1990, February during 1991-1994 and March during 1995-2006. We match the list of companies in the Fortune survey with list of companies in the CRSP database. Approximately 7% of the companies in the surveys are not publicly traded or are missing return data on CRSP

significant. We also see in Tables 1b and 1c that the long-short portfolio tilts toward high beta, small-cap, value, and low momentum.

The CAPM and the three and four-factor models

Fama (1991) noted long ago that market efficiency per se is not testable. Market efficiency must be tested jointly with an asset pricing model, such as the CAPM, the three-factor model, or the four-factor model. For example, a positive CAPM-alpha of small-cap stocks or stocks of spurned companies might indicate that the market is not efficient or that the CAPM is a bad model of expected returns. But when it comes to tests of market efficiency the CAPM is quite different from the three or four-factor models. While the four-factor model has become the common standard by which performance is evaluated, its logic, unlike that of the CAPM, is under debate. The logic of the CAPM is clear since beta, its measure of risk, is derived from a general equilibrium where investors form portfolios on the mean-variance efficient frontier. But the three and four-factor models are ad-hoc models of factors that have been found, by empirical analysis, to be associated with stock returns. Fama and French (1992) argued that small-cap and value represent objective risk but much of the evidence is inconsistent with their argument. For example, Lakonishok et al (1994) found that value stocks outperformed growth stocks in three out of four recessions during 1963-1990, inconsistent with the view that value stocks are riskier. Similarly, Skinner and Sloan (2002) found that the relatively high returns of value stocks are not due to their higher risk. Rather, they are due to large declines in the prices of growth stocks in response to negative earnings surprises.

Statman, Fisher and Anginer (2008) argued that the four-factor model is indeed a good model of expected returns but the factors of small-large, value-growth and

momentum proxy for affect. Affect is the feeling of ‘goodness’ or ‘badness,’ a feeling that occurs rapidly and automatically, often without consciousness, and the affect heuristic has been described by Slovic, Finucane, Peters, and MacGregor (2002). Specifically, the negative affect of spurned companies is associated with high subjective risk of their stocks, and that subjective risk augments the objective risk measured by beta. Subjective risk, like objective risk, is compensated by higher returns.

We found that the alpha of the long-short spurned-admired portfolio by the CAPM is positive and statistically significant and that the corresponding alpha by the four-factor model is not statistically significant. We interpret these findings as indicating that investors in a long-short portfolio of stocks of spurned and admired companies received higher returns than warranted by the objective risk of the CAPM’s beta but no more than the returns warranted by the combination of the objective risk of beta and the subjective risk of negative affect proxied by the tilts toward small-cap, value, and low-momentum stocks.

Returns associated with changes in reputations

As noted earlier, we find that the returns of stocks of admired companies lagged those of stocks of spurned companies. Moreover, we also find that stocks of companies that moved up the reputation scale lagged stocks of companies that moved down. This is especially noticeable at the extremes. We begin by dividing the companies in the Fortune surveys into quartiles along the reputation scale. Next, we divide the stocks in the most admired quartile into two groups, those whose reputation increased relative to their reputations in the preceding year by more than the median increase in the quartile, and

those whose reputation increased by less. We do the same for the stocks in the most spurned quartile.

We show in Table 2a that the mean annualized return of the stocks in the spurned quartile whose reputation declined relative to the median was 18.76% when stocks are equally weighted. This return exceeds by 5.60 percentage points the corresponding 13.16% mean annualized return of stocks in the admired quartile whose reputation increased relative to the median. The corresponding numbers when returns are value-weighted are 16.40%, 6.71 percentage points and 12.60%. Table 2b shows that the annualized CAPM-alpha of a portfolio long in equally-weighted stocks of spurned companies whose reputation declined and short in equally-weighted stocks of admired companies whose reputation increased is 5.70%. Table 2c shows that the annualized CAPM-alpha when stocks are value-weighted is 7.45%. Both are statistically significant. The corresponding four-factor alphas in Tables 3b and 3c are 4.02% and 2.66%. The second is statistically significant but not the first.

Dispersion

Not all stocks of spurned companies do well. Indeed many of them do poorly. The return advantage of the spurned stocks over the admired stocks comes from spurned stocks which do exceedingly well, more than compensating for the poor performance of other spurned stocks. By comparison, the returns of admired stocks are middling. Table 3 shows that the 18.57% mean annual return of spurned stocks exceeded the 15.56% mean annual return of admired stocks by 3.01 percentage points.² But the 12.52% median

² The mean returns in table 2 do not match precisely the mean returns in Table 1a because they are measured differently. In Table 3 there are fewer returns of the early years of the survey and more of the more recent years because the number of companies in the survey increased

annual return of spurned stocks fell slightly short of the median 12.81% return of admired stocks. The difference between means and medians indicates that distribution of returns of spurned stocks is skewed to the right relative to the distribution of returns of admired stocks. The skewness of the distribution of returns of the spurned stocks exceeds that of admired stocks by 0.42. Moreover, there is a wider dispersion of returns of spurned stocks than admired stocks. Only one of the dozen bottom-return stocks was an admired stock before it fell. This was the infamous Enron which was among the most admired in the 2001 survey and lost 98.96% of its value during the following 12 months. More common are Consolidated Freightways which was among the spurned in the 2002 survey and lost 99.23% of its value during the following 12 months, and Comdisco which was among the spurned in the 2001 survey and it lost 95.88% of its value during the following 12 months.

Only three of the dozen top-return stocks were admired before they gained their high returns. The best among them was EchoStar Communications which was among the admired in the 1999 survey and gained 674.27% during the following 12 months. More common were America Online which was among the spurned in the 1998 survey and gained 770.59% during the following 12 months, and Avaya which was among the spurned in the 2003 survey and gained 678.43% during the following 12 months. The difference in dispersion is evident in the distribution of returns in the two portfolios. The return of admired stocks at the first percentile was -62.40%, but lower, -77.33, among spurned stocks. The return of admired stocks at the 99th percentile was 135.13%, but it

over time. In contrast, in Table 1a each year is represented equally since we report portfolio returns with no regard to the number of stocks in them.

was higher, 186.80%, among spurned stocks. The difference in the distributions of returns of admired and spurned stocks is statistically significant.

The high dispersion in the distribution of both spurned and admired stocks makes diversification crucial. It also cautions us against the pitfalls of what Kahneman and Tversky called “the belief in the law of small numbers,” where we draw broad conclusions from small samples. Consider the study by Anderson and Smith (2006), “A great company can be a great investment”. Anderson and Smith studied the performance of an equally-weighted portfolio composed of the stocks of top-10 companies in the Fortune survey and found that it beat the S&P 500 Index during 1983 – 2005. The top-10 companies in Anderson and Smith’s study are the top stocks by vote of all Fortune respondents, regardless of industry affiliation. That list is different from the list of companies by ratings assigned by Fortune respondents with industry affiliation. Nevertheless, we might have concluded, based on the top-10 list by respondents with industry affiliation that stocks of great companies do indeed make great investments. Table 5 shows that the annualized return of an equally-weighted top-10 portfolio was 16.64%, beating the 13.38% return of the bottom-10 portfolio. The 14.60% return of the top 11-20 portfolio, the portfolio of the next 10, was still slightly better than the 14.06% return of the bottom 11-20 portfolio. But the 15.93% return of the top 21-30 portfolio lagged substantially the 22.27% return of the bottom 21-30 portfolio and the same is true for portfolios 31-40 and 41-50. A great company can surely be a great stock, but Anderson and Smith’s findings cannot be generalized into a statement that stocks of great companies are likely to make great investments.

Conclusion

Do stocks of admired companies yield admirable returns? Are increases in admiration followed by high stock returns? And how reliable is the relation between admiration and returns? These are the questions we answer in this paper. We study Fortune magazine's annual list of "America's Most Admired Companies" and find that stocks of admired companies had lower returns, on average, than stocks of spurned companies from April 1983 through December 2007. Moreover, we find that increases in admiration were followed, on average, by lower returns. We also find that the dispersion of returns is high, especially in the spurned portfolio. This implies that investors who want to benefit from the return advantage of spurned stocks must diversify widely among them.

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Table 1a: Annualized returns of the spurned and admired portfolios: 1983-2007

Portfolio	Spurned Portfolio	Admired Portfolio	Difference (pp)
Stocks are equally weighted in the portfolios	18.34%	16.27%	2.07
Stocks are value weighted in the portfolios	16.12%	13.81%	2.31

Table 1b: Performance of the long-short equally-weighted spurned and admired portfolios

		Annualized Alpha	MKT	SMB	HML	MOM	Adj R²
CAPM							
	Coef	2.05%	-0.033				0.010
	<i>t-stat</i>	2.025**	-7.921**				
4-Factor Model							
	Coef	0.82%	0.078	0.315	0.205	-0.034	0.275
	<i>t-stat</i>	0.945	16.127**	46.864**	22.890**	-6.469**	

Table 1c: Performance of the long-short value-weighted spurned and admired portfolios

		Annualized Alpha	MKT	SMB	HML	MOM	Adj R²
CAPM							
	Coef	2.56%	-0.061				0.020
	<i>t-stat</i>	1.927**	-11.185**				
4-Factor Model							
	Coef	-0.25%	0.103	0.261	0.400	-0.017	0.199
	<i>t-stat</i>	-0.206	15.407**	28.186**	32.380**	-2.400**	

** Statistically significant at the 0.05 level.

* Statistically significant at the 0.10 level.

Table 2a: Annualized returns of a portfolio of spurned stocks whose ratings have deteriorated during the preceding year and a portfolio of admired stocks whose ratings have improved: 1983 - 2007

Portfolio	Spurned Portfolio	Admired Portfolio	Difference (pp)
Stocks are equally weighted in the portfolios	18.76%	13.16%	5.60
Stocks are value weighted in the portfolios	19.31%	12.60%	6.71

Table 2b: Performance of the long-short equally-weighted spurned portfolios of stocks whose ratings have deteriorated during the preceding year and a portfolio of stocks whose ratings have improved.

		Annualized Alpha	MKT	SMB	HML	MOM	Adj R2
CAPM							
	Coef	5.70%	-0.087				0.010
	<i>t-stat</i>	2.069**	-7.848				
4-Factor Model							
	Coef	4.02%	0.121	0.502	0.416	-0.164	0.120
	<i>t-stat</i>	1.553	8.541	25.428	15.799	-10.585	

Table 2c: Performance of the long-short value-weighted spurned portfolios of stocks whose ratings have deteriorated during the preceding year and a portfolio of stocks whose ratings have improved.

		Annualized Alpha	MKT	SMB	HML	MOM	Adj R2
CAPM							
	Coef	7.45%	-0.152				0.025
	<i>t-stat</i>	2.450**	-12.559				
4-Factor Model							
	Coef	2.66%	0.122	0.277	0.739	-0.092	0.122
	<i>t-stat</i>	2.069**	7.777	12.734	25.487	-5.396	

** Statistically significant at the 0.05 level.

* Statistically significant at the 0.10 level.

Table 3: Distribution of returns of stocks in the spurned and admired portfolios: 1983 - 2007

	Spurned	Admired	Difference (pp)
Mean return	18.57%	15.56%	3.01
Median return	12.52%	12.81%	-0.29
Skewness	3.36%	2.94%	0.42
1st percentile return	-77.33%	-62.40%	-14.93
10th percentile return	-31.35%	-23.71%	-7.63
25th percentile return	-8.91%	-6.51%	-2.40
75th percentile return	37.37%	32.57%	4.81
90th percentile return	68.98%	55.10%	13.88
99th percentile return	186.80%	135.13%	51.66

Kolmogorov-Smirnov test for the equality of distributions

KS Stat 5.649

p-value <.0001

Table 4: Returns of equally-weighted portfolios of 10 stocks each, with top and bottom Fortune ratings

Portfolio		Portfolio		Difference (pp.)
Top 1-10 stocks	16.64%	Bottom 1-10 stocks	13.38%	3.26
Top 11-20 stocks	14.60%	Bottom 11-20 stocks	14.06%	0.54
Top 21-30 stocks	15.93%	Bottom 21-30 stocks	22.27%	-6.34
Top 31-40 stocks	16.05%	Bottom 31-40 stocks	18.65%	-2.60
Top 41-50 stocks	15.76%	Bottom 41-50 stocks	21.17%	-5.41