
PRACTITIONER'S DIGEST

The “Practitioner’s Digest” emphasizes the practical significance of manuscripts featured in the “Insights” and “Articles” sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.



INSIGHTS

BEN GRAHAM'S VALUE APPROACH: CAN IT STILL WORK?

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Martin Fridson

Fundamental analysis is making a comeback, following the price collapses in dotcoms and telecoms. This inevitably puts the spotlight on Benjamin Graham (1894–1976), “The Father of Security Analysis.” Adopting his creed does not by itself guarantee superior results, however.

To begin with, investors must define the Graham method in view of considerable evolution in the master’s thinking over a 60-year career. The empirical evidence indicates, moreover, that reducing Graham’s approach to a quantitative formula does not produce superior performance. Graham’s most celebrated pupil, Warren Buffett, has been strongly influenced by other investment thinkers and freely acknowledges buying entirely different stocks than Graham would.

Benjamin Graham’s notion of acquiring a company at less than its breakup value remains a useful way of thinking about prices. Investors cannot count on beating the averages, however, by picking any random stock displaying a high net current asset value. They must do the hard analytical work of separating the nuggets from the worthless overburden.

IS STOCK RETURN PREDICTABILITY SPURIOUS?

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Wayne E. Ferson, Sergei Sarkissian and Timothy Simin

If expectations about a stock’s return are dependent through time, then variables like dividend yields and yield spreads can appear to be better at predicting returns than they actually are. This is a potentially serious problem when implementing tactical asset allocation strategies, actively managing a portfolio, measuring investment performance, attempting to time the market, and in other situations where analysts use lagged variables to predict returns. We show that searching for predictor variables using historical data can increase

the likelihood of finding a variable with spurious regression bias. Such a variable appears to have worked in the past, but will not work in the future. A simple transformation of the predictor variables can be used to reduce the risk of finding spurious predictive relations.

DO SHORT SELLERS CAUSE THE WEEKEND EFFECT?

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Honghui Chen and Vijay Singal

The weekend effect has been puzzling observers for decades. We suggest that this price pattern occurs because short sellers are unable to trade over the weekend. This inability to trade causes them to close many of their speculative positions on Fridays and reestablish new short positions on Mondays, making stock prices rise on Fridays and fall on Mondays. We provide several pieces of evidence to support the hypothesis. The weekend effect is significantly larger for high short-interest stocks than for low short-interest stocks. The substitution of speculative short sales by put options results in the diminishing of the weekend effect for stocks with actively traded options. Further analysis of special cases such as zero short-interest stocks, IPOs, and more volatile stocks yields additional support for the hypothesis.

The weekend effect continues to be important: Though it has weakened for the 100 largest stocks with actively traded options, it persists, almost unabated, for stocks with less actively traded options. The magnitude of the mispricing is about 0.30% per weekend. Unfortunately, none of the available financial instruments can profitably capture the weekend effect because the trading costs can be large. Perhaps, that explains the persistence of the weekend effect.

Nonetheless, investors can benefit from this knowledge by slightly altering their trading patterns. Investors, and financial institutions, should sell stocks on Fridays and buy them on Mondays, instead of buying them on Fridays and selling on Mondays. This advice applies especially to stocks that do not have actively traded options.

TIME DIVERSIFICATION

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Jack L. Treynor

The risk surrounding the market's rate of return—change in dollar value, divided by initial dollar value—is roughly stationary across time. To maintain constant dollar risk, investors concerned with their terminal wealth must sell when the stock market rises and buy when it falls. The frequent trading is probably the reason why few investors have tried to time diversify.

Consider an asset whose *dollar* gains and losses are in one-to-one correspondence with the stock market's *rate of return*: if the risk surrounding the latter is indeed stationary across time, then the risk surrounding the former will also be stationary. Using this principle and elementary calculus, we derive the asset.

Although an asset with constant dollar risk does not exist in nature, it can be approximated with actual investment positions. The key to the approximation is the fact that

a diversified asset's beta expresses a power relation between its value and the market level.

ENHANCED EQUITY INDEXERS: COMMON TRAITS AND SURPRISING DIFFERENCES **PAGE 48**

James Scott and Margaret Stumpp

This paper investigates the characteristics of 44 enhanced S&P 500 index funds. To become part of our dataset, a fund needed to appear in a commercial database, to have tracking error between 0.25% and 3% over a 5-year period, to have at least \$250 million in assets and to avoid the use of leverage. Nor could it be a pure index fund simply gone awry.

On average, these funds outperformed the S&P 500 while controlling risk. Their outperformance was 0.55% per year for the five years ending December 31, 2002. Their quarterly batting average was 0.578.

To maintain low tracking error relative to the S&P 500, enhanced index managers appear to keep cash levels low and to maintain close control over the exposure of their fund to size and style deviations from the S&P 500. Approximately half of the enhanced index tracking error appeared due to small deviations from benchmark for these three factors. The remaining tracking error seemed to reflect idiosyncratic security selection and, surprisingly, the correlations of fund value added relative to the S&P 500 were quite low.

FUND MANAGERS MAY CAUSE THEIR BENCHMARKS TO BE PRICED "RISKS" PAGE 61

Michael Stutzer

Fund managers now commonly try to beat specific benchmarks (e.g. the S&P 500), and the widespread dissemination of return statistics on both index and actively managed funds makes it plausible that some individual investors may also be trying to do so. Academics now commonly evaluate fund performance by the size of the "alpha" from a multifactor generalization of the familiar Capital Asset Pricing Model, i.e. the size of the intercept in a linear regression of the fund's returns on the returns of a broad based market index and other "factor" portfolios (e.g. those proposed in the influential work of Eugene Fama and Kenneth French).

This paper theoretically and empirically argues that these two seemingly disparate facts may be closely connected. Specifically, the attempt of fund managers and/or individual investors to beat benchmark portfolios may *cause* those benchmarks (or proxies for them) to appear in the multifactor performance evaluation models advocated by academics. This casts additional doubt on the currently problematic academic presumption that the non-market factors proxy for predictors of fundamental risks that can affect future investment opportunities. Instead, the non-market factors in the Fama and French equity fund performance evaluation model may proxy for growth-oriented index portfolios, which some try to beat, and value-oriented index portfolios, which others try to beat.