Summary

This paper investigates the risk versus mispricing explanation of superior returns to contrarian strategies using the interactions between value-to-market indicators and corporate financing transactions that increase or decrease a firm’s outstanding equity. Portfolio-level analyses and firm-level cross-sectional regressions indicate that the well-documented contrarian profits soar when value stocks which repurchase shares (value repurchasers) and growth stocks which issue shares (growth issuers) are considered. The results also show that value-to-market ratios cannot capture the cross-sectional variation in expected stock returns when value issuers and growth repurchasers are considered. Based on various risk measures, we find that value repurchasers are not riskier than growth issuers. Furthermore, examination of past and future growth rates, analyst estimates of long-term growth, and sensitivity of portfolio returns to investor sentiment support the misvaluation explanation for the superior returns of value stocks.

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