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Generating Profits through Graham's Value investing using Exit Strategy : An Empirical Analysis[1]

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Abstract

Based on a sample of 49,117 firm-year observations for BSE listed firms spanning over 15 years from 2003 to 2017, the study seeks to evaluate the profitability of Benjamin Graham's stock selection principles in the Indian stock market. The results reported that the stocks failed to generate significant alpha if they are held for 1 or 2 years. However, on introducing Graham's exit advice, the performance of portfolios comprising firms with high earnings yield and dividend yield, discount to book value, and net current asset value per share improved significantly in one year period and such stocks were able to withstand market downturns. Consequently, the results imply that the exit strategy weighs on the buy and hold strategy in terms of the excess risk-adjusted return. Also, the findings have significant implications for practitioners in the pursuit of "alpha."

JEL Code : G10; G11; G12; G14
Keywords : Value Investing; Graham; Carhart Four-Factor Model; Stock Selection; Stock Market; India

I. Introduction

Investing in stocks is not an easy job and nobody bets his bottom dollar in the markets. On the other hand, the desire to earn better returns motivates people to invest in the stock market. Alternate schools of thought exist concerning wealth creation from the market by focusing either on value stocks or growth stocks. In the United States, however, Fama and French (1998) observed a 7.68 percent annual return premium in value stocks over

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exit in an investment strategy. Also, we find that four rules, in particular, look to be promising: criteria 1 (earning yield is more than twice the rate of corporate AAA bond yield), criteria 3 (dividend yield more than 2/3 of corporate AAA bond yield), criteria 4 (Current price of the stock should be equal or less than from 2/3 of its Book Value per share) and criteria 5 (current stock price is less than from 2/3 of its net current asset per share value). It is recommended to give due consideration to these rules while investing in common stocks. Additionally, equities that are offered at a considerable discount to net current asset value and also meet the earnings and dividend yield criteria may experience a price appreciation of more than 50% in a year. Hence the results suggest that the investors can set a selling target of more than a 50% price rise in such equities. Moreover, the rules can withstand a market downturn, and mispricing caused by investors' cognitive biases tends to correct itself in the first year, resulting in high-risk adjusted returns.

Furthermore, the study offers useful insights for fund managers and investors. To begin with, stock selection guidelines and exit criteria may be useful tools, similar to ETFs and index funds, which are passive investment products. Second, investment managers can observe the rules in the years of the global financial crisis as well. In addition, the primary inspiration for this research arises from the easy online tools that allow investors to filter companies. While it is critical to purchase the right stocks, it is far more necessary to sell them to realize the profit. As a result, conditioning a value investment strategy with exit options is intriguing. Also, the findings have significant implications for practitioners in the pursuit of "alpha." On the other hand, the strategy is simple to implement as it relies solely on publicly available information, does not require long time series data, and is led by cost-effective fundamental analysis methodologies. Graham once cited that the practitioners and investors employing any strategy would certainly fail in the long run if they don't remember the three rules of price, earnings, and dividend (Graham, 1949). As a consequence, the research recommends that one may invest safely in shares that satisfy all three of these criteria, as well as contemplate selling at the right moment to maximise profit.

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