# Doing Good by Beating the Market


By Theo Vermaelen  and Urs Peyer, INSEAD Professors of Finance

**Our PV Buyback USA fund pays 10% of its performance fees to help INSEAD students in financial need. Here's how it works.**

In June 2011 we launched the PV buyback USA fund and agreed to pay 10 percent of our performance fees to INSEAD to help MBA's in financial need. So far (on November 23) we earned a return of 47.5 percent, beating our benchmark[1] by 14.8 percent. Because of this performance 9,000 euros were donated to INSEAD so far. Today we are happy to report that Ojo Oluwaseun Samson, a Nigerian student in the MBA 13D class, is the first recipient of the PV Buyback USA award.

The fund invests in 60 US-listed companies that announce share buybacks to take advantage of an undervalued stock price. We use a number of indicators to judge whether the buyback is driven by undervaluation: market-to-book ratios, firm size, prior return and stated motivation in the press release.  We like to invest in small, beaten up companies that trade at low

market-to-book ratios and where the management states that it is repurchasing shares because of undervaluation. The strategy is based on extensive research on buybacks during the last 30 years. The logic behind these selection criteria is straightforward: when a high market-to-book company buys back stock it may indicate a decline in growth prospects, not undervaluation. Small stocks are less followed by analysts and are therefore more likely to be miss-priced. Obviously it is also less likely that a stock that has outperformed the market during the last 6 months is buying back stock because of undervaluation.

**Markets obsessed with short-term**

We believe the anomaly persists because the obsession of many analysts and investors with short term earnings. Although we keep telling our students that you should use discounted cash flow to value companies, the fact remains that many investment professionals use earnings multiples to price stocks. This puts excessive weight on short term performance and may create a situation where the management may have a competitive advantage in valuing their business. In other words, they may be better able to judge whether the earnings shortfall is simply a short-term problem that does not affect the long term potential of the company.

Sometimes the collapse of the stock is caused by a short-seller attack. For example on October 24 2013 Muddy Waters a notorious short-seller accused NQ mobile, a mobile security firm, of fraud. As a result the stock fell from $25 to $12. The company denied the allegations and announced it will buy back stock to take advantage of the undervaluation and three senior executives announced they will invest $3 million of their personal funds. Since then the stock has somewhat recovered to $13 but still remains significantly below the pre-attack level. Note that it may well be that in the end in turns out that Muddy Waters is right. But by holding a diversified portfolio of stocks we believe that, on average, managers are right and the market is wrong.

The NQ mobile buyback is not driven by inside information but by disagreement with the market’s interpretation of publicly available information. Another example of this type of motivation is the buyback announced by eHealth, a company that sells insurance over the internet. When Obamacare was signed into law in 2010, the stock took a big hammering as analysts believed government websites would take away their

business.  The management disagreed as they believed the government would need partners in the private sector. Today the management has been proven right, especially after the troubles with the government-run website, Healthcare.gov. The stock is up more than 200 percent since the buyback announcement.

**Not shunning "sin stocks"**

Although we help MBA students in need, we are different from the typical socially responsible investment fund (SRI).  These funds typically will not invest in "sin" stocks. The fact is that we have a number of companies in our portfolio that are categorized as sin stocks. Actually our most successful investment was Multimedia Gaming, a sin stock that we sold at a 600 percent profit. This is not surprising as the most prominent research on this topic (published by Finance professors in an a-journal[2]) shows that sin stocks beat the market.  Hence unlike many other SRI we won't sacrifice investor returns  to do good, but want to make sure that this is a true win-win situation: we will support students in need when our investors earn abnormal returns.

Although our outperformance is large in percentage terms, and although we nearly doubled our assets under management to $15 million since inception, we remain a small fund, which explains the relatively small contribution to INSEAD.  Of course, we hope that our fund will grow in part by the support of the INSEAD community. So far we are grateful to our 10 INSEAD investors for their continuous support.

[1] We take the Russell 2000 as a benchmark because we mainly invest in small and medium sized companies and because we have approximately the same risk, either measured by volatility or beta.

[2] "The Price of Sin : The Effects of Social Norms on Stock Markets", Harrison Hong and Martin Kacperczyk, Journal of Financial Economics, 2009.

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