IESE Business School University of Navarra

2008: A good year for the stock market?

April 21, 2008

Stock markets around the world got off to a rocky start in 2008. Will this be a good year for the stock market?

The year 2008 started out rather harshly for Spain's Mercado Continuo. A new paper by IESE Prof. Pablo Fernández and research assistant Vicente J. Bermejo highlights this situation. In their paper, "Spanish Companies in 2007 and the Period Between 1993-2007: Profitability and Value Creation" ("Las empresas españolas en 2007 y en el periodo 1993-2007. Rentabilidad y creación de valor"), Fernández and Bermejo studied the 125 companies traded on the Spanish stock market, comparing last year's market situation with the first 17 days of this year. The results speak for themselves.

At the outset of 2008, 119 companies had destroyed value compared to 94 in the whole of 2007. But it's not just the number of companies involved, but the actual sum of money destroyed, which those companies represent. In all of 2007, 15 billion euros was destroyed; at the start of the new year in 2008, that figure has jumped to 89 billion euros.

Another indicator that is cause for pessimism is profitability: 112 companies offered negative profits in the first days of January, compared to 74 the year before.

The year 2007 closed with Telefónica atop the list of 31 companies that had created value for shareholders, followed by Arcelor, Iberdrola, Acciona and Gas Natural. Nonetheless, the most profitable company was CAF, in a year in which 98 of the 125 companies delivered profitability below that of the IBEX 35 (10.7 percent). Although the average return in 2007 was negative (-6.4 percent), the weighted average market capitalization was positive (6.4 percent) due to the higher profitability of the large companies, particularly Telefónica.

©IESE Business School

With regard to the oscillating share prices, 24 companies reached highs amounting to more than twice the minimum trading price, while 78 reached highs 1.5 times greater than their respective minimums, with the average MAX/min value of 1.82.

Midsized companies lead in value creation

The study also looked back to analyze the period between 1993 and 2007, in which 71 companies were listed without interruption on the Spanish stock market.

The analysis of the capitalization-weighted return of these firms shows that they outperformed the weighted return of the IBEX 35. In other words, the return on small companies was greater than that of their larger counterparts in the average from this period.

While in the decade between 1989 and 2000 the IBEX 35 was higher than the Madrid Stock Exchange General Index (IGBM), that trend was reversed starting with the new millennium, due to the fact that the return on small companies was, on average, higher than that of the large firms.

The authors qualify this by categorizing companies as either large, medium-large, medium, medium-small or small. Entering into the detail, one observes that the smallest of these companies generated lower-than-average returns. The standout group is that of the medium-small and medium-large companies.

Up until the year 2000, large companies saw greater capitalization growth than small firms, with Telefónica being the paradigm of these fluctuations: Whereas in 1992 Telefónica contributed 14.3 percent of the capitalization of the 71 companies studied, in 1999 the percentage ascended to 27.7 percent, before eventually dropping to 17.3 percent in 2007.

And it was none other than Telefónica, the company that contributed the most value last year, topping this category in the total accumulated during the period studied, representing 19.3 percent of the total. The top 20 companies combined to create 89 percent of the value.

Nevertheless, the most profitable for shareholders was Sotogrande. Out of the 71 companies studied, 41 saw returns above the dividend-adjusted IBEX.

Other considerations on return

The authors also address the question of whether a company's return for a given year is related to that obtained the previous year. To do so, they put together four portfolios with the

©IESE Business School

same weight (investment) in each company.

On average, the portfolio made up of the least-profitable companies from the previous year actually saw a higher return than portfolios comprising more profitable ones (24.3 percent versus 16.3 percent).

One fairly well-established idea is that in order to see greater profitability, one must assume a greater risk. One way to measure the risk of stocks, for instance, is volatility, which measures their return variability. If a stock yields the same return each year, it has zero volatility.

Between 1992 and 2007, a total of 68 companies had a volatility greater than that of the IBEX 35. But that increased volatility did not translate into a profitability increase for the period.

Will the market be able to reverse this trend in 2008?

www.iese.edu/insight

©IESE Business School