

Should good stocks have high prices or high returns? Evidence of financial advisors' labile expectations^{*}

June 27, 2008

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Abstract

Would you rather invest in a risky or a safe company? Think carefully. Financial advisors choose both because they would each provide superior returns! This conclusion comes from a survey of 742 Finnish advisors using a between-subjects experimental manipulation. We ask about requiring a risk premium in one mode, and about expected returns in the other mode. Firm level risk factors cause an increased return requirement in the first mode, but lead to lower return expectations in the second mode. Our results imply that depending on what a client asks and how he or she asks it, the advice received can vary significantly.

Keywords: Experiment, financial advisors, expected returns, risk factor

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^{*} We thank Pasi Poikkeus (Mandatum Private Bank) and Antti Lehtinen for help in developing the questionnaire and Atso Andersen for help in accessing the respondents. We thank Matti Keloharju, Samuli Knüpfer, Meir Statman, Sami Torstila and Graduate School of Finance (Finland) seminar participants for comments. Financial support from the OMX Exchanges' foundation is gratefully acknowledged.

1. Introduction

In many cases investors expect “good” companies to deliver above average returns, where “good” can be variously defined. The reputation scores from Fortune magazine’s America’s Most Admired Companies reveal that survey respondents (senior executives, outside directors and financial analysts) expect most value as a long-term investment from large-cap, high market-to-book firms with good quality management (Shefrin and Statman, 1995). Portfolio managers and analysts in general expect safer stocks to have better return prospects compared to riskier stocks (Shefrin, 1999). The Fortune ranking is the most important indicator used by MBA students in judging investment value, while the second most important indicator is sales growth (Barber, Heath, and Odean, 2003). However, not all professionals expect good companies to produce superior returns. Bloomfield and Michaely (2004) find that senior analysts expect high market-to-book firms to be on average overpriced, and to have lower future returns.

Good companies may not deliver the returns that investors expect. Conventional asset pricing theory says that any “good” characteristic that is priced by the market (such as low leverage) is associated with lower, not higher, return expectations: A good rating in the characteristic causes a decrease in the required return, leading to a higher current price, and a lower future return on average. A characteristic not priced by the market, on the other hand, would impact the current price, but would not have any systematic relation to future returns. An example of such a characteristic might be the firm’s profit margin. Empirically, stocks commonly judged as good do not seem to provide superior returns, and may indeed provide lower returns. This is true for large firms (Banz, 1981), firms with high market-to-book ratios (Fama and French, 1992), high historical sales growth (Lakonishok, Shleifer, and Vishny, 1994), high expected earnings growth (La Porta, 1996), low leverage (Bhandari, 1988), good stock liquidity

(Amihud and Mendelson, 1986), media coverage (Fang and Peress, 2007), as well as high admiration scores at the Fortune list (Statman, Fisher, and Anginer, 2008).

Do market participants rationally choose to hold beliefs that go against asset pricing theory as well as empirical evidence? Or are they confused by the logic of risk and return? In the latter case their preferences and expectations might be unstable, possibly reversing as a result of manipulating the way the question is posed. Even normatively equivalent, but differentially framed, descriptions of the same decision problem can cause changes in preferences (Tversky and Kahneman, 1981; see Kuhberger, 1998 for a review). In the realm of stock return expectations, previous studies have found framing effects (Glaser et al., 2007) and anchoring effects (Kaustia, Alho, and Puttonen, 2008).

To test the hypothesis of labile expectations we study financial advisors' perceptions of firm characteristics and expected returns. Financial advisors are an important group to study as they exert an increasingly important influence on individual investors' investment decisions (see e.g. Bluethgen et al., 2007). Hong et al. (2008) show theoretically that even well-intentioned advice can contribute to the formation of an asset pricing bubble.

We utilize an online questionnaire to obtain data from Finnish professional investment advisors. With a 68% response rate we receive a comprehensive dataset of 742 responses. We form two randomly selected groups of respondents, stratified by age, gender, experience, and location. In one version we ask for the impact of a set of firm characteristics on return expectations. In the other version we ask whether the respondents would require extra return given a particular characteristic of the firm.

We find that advisors expect higher leverage, poorer growth prospects, and less liquid stock to lead to lower returns. The majority expects no effect on returns due to less analyst following, but even in that case a clearly higher portion of respondents expects lower returns

rather than higher returns. At the same time, the majority of advisors associate all of these characteristics with risk and require extra returns for bearing that risk in the other experimental mode. Thus, our findings suggest that professionals are sensitive to psychological manipulation leading to inconsistent perceptions of the relation between risk and return. Giving consistent advice is a necessary condition for providing valuable client service, which is clearly in the interest of financial institutions.

To what extent might these results generalize to other populations of financial market professionals? Particularly, the strength of these effects could be a function of the individual's experience and sophistication. Surprisingly, we find that a higher level of expertise does not diminish the effect. For this reason, as well as other reasons discussed in Section 3.3, we believe the findings to have reasonable external validity. In the remainder of the paper, Section 2 discusses sample selection and survey design. Section 3 presents the results, and Section 4 concludes and discusses implications.

2. Data and methodology

2.1. Sample

The target group of the survey is professional financial advisors who have passed the Finnish Association of Securities Dealers (FASD) General Securities Examination. The FASD is a co-operation and self-regulatory organization of the Finnish investment services industry. It maintains and develops a system for investment services degree, which consists of two examinations: FASD General Securities Examination and FASD Investment Advisor Examination. Both examinations have been part of the self-regulation of FASD since 2001. The objective of the system is to improve the financial skills and knowledge of the people who work in the industry as well as to enhance the image of the industry. However, the examination is not

required by the law. The exam covers a wide range of areas such as general economics, financial statement analysis, financial instruments, derivatives, valuation, mutual funds, taxation and legislation. The relation between risk and return (e.g. mean-variance portfolio theory, capital asset pricing model) is an important part of the exam material.

We carried out a web-based survey targeted to 1,465 investment advisors who had passed the first level examination organized by FASD as of May 2005 and had given permission to use their contact information for research purposes. The participants were approached by e-mail, which had a link to the questionnaire. The participants were given time to answer the questionnaire from May 5 to May 31, 2006. On May 27 a reminder was sent to those who had not yet responded to the questionnaire. Out of the 1,465 emails sent, 368 were either undeliverable or the recipient was out-of-office for the whole period during which the survey was carried out. Hence, a total of 1,097 emails reached their targets. The questionnaire was answered 762 times.

After filtering out duplicate answers and some answers from people outside of our mailing list who had not passed the FASD examination the total number of respondents is 742. This is 68% of those who received the email by May 31. The typical response rate in these types of surveys is 10 to 20%. The exceptionally high response rate to our survey may have been influenced by the fact that it was the first survey targeted to the subject pool. Given the high response rate, the risk of non-response bias is much lower than typically.

Of the 742 respondents, 53% have a college degree and 20% had also passed the second level FASD exam in addition to the first level exam. Over 80% work in a bank. The average respondent has six years of work experience.

2.2. *Survey design*

Before sending invitations to participate the investment advisors were randomly divided into three groups of equal size corresponding to three different experimental modes. The groups were stratified by the following variables: year when examination was passed, gender, employer, age, and hometown (the capital Helsinki, where the financial industry is concentrated, vs. other). Number of years since passing the examination is a proxy for job-related experience. Nonresponse appears random across the three groups, so the variables used in the stratification are similarly distributed in the final answers of the three groups. All groups were asked about the relation between returns and firm characteristics. The survey explains that return refers to total returns to shareholders.

In the first group the question is framed in terms of required return premium, for example: “In order to invest in the stock of a company that is more leveraged than average, I would require higher than average return. [Yes/No]”. We refer to this as the “required returns mode”. In the second and third groups the question is framed in terms of expected returns, for example: “If a company has more debt than average do you expect it to provide [Higher return/Lower return/No effect]”. In thinking about these questions the respondents were instructed to consider a situation where the company is average in all other respects. As mentioned, there was a third group as well. The only difference between the second and the third group is that we reverse the reference to the firm characteristics, i.e., “If a company has *less* debt than average do you expect it to provide [Higher return/Lower return/No effect]”. It turns out that the differences in the results obtained in the second and the third group are small and statistically insignificant except in one

case.¹ We therefore collapse over this variation, and henceforth refer to the combined results of groups two and three when we talk about the “expected returns mode” of the survey.

We asked about four firm characteristics: leverage, growth prospects, stock liquidity, and analyst coverage. Theory suggests that these characteristics should all be related to expected returns. Leverage is a well-established risk factor: the equity beta of a company should increase in its debt-to-equity ratio. Empirical evidence is consistent with this (e.g. Bhandari, 1988; Fama and French, 1992). We ask for growth prospects in terms of analysts’ consensus five-year earnings growth estimate. The return spread between high (value) and low book-to-market (growth) stocks is a risk factor in the Fama-French three-factor model (Fama and French, 1993). To the extent that poor growth prospects are correlated with exposure to the value factor, it should lead to higher expected returns. This is the case empirically (La Porta, 1996).

The third characteristic that we examine is stock liquidity. The models of Amihud and Mendelson (1986) and Acharya and Pedersen (2005) imply a positive relation between future returns and poor liquidity (i.e., illiquidity). Empirically, the case of illiquidity is perhaps less straightforward, as it can be measured in various ways and is correlated with other important attributes, such as firm size. Nevertheless, several studies generally support a positive relation between illiquidity and returns, consistent with the risk factor hypothesis (Amihud and Mendelson, 1986; Amihud and Mendelson, 1989; Brennan, Chordia, and Subrahmanyam, 1998; Pastor and Stambaugh, 2001; Amihud, 2002 and others). Some studies, however, find that illiquidity is not priced (see e.g. Eleswarapu and Reinganum 1993; Chalmers and Kadlec 1998).

¹ In the case of stock liquidity, the percentage expecting no effect is larger (29% vs. 16%) when asked about the effects of good liquidity as opposed to asking about the effects of poor liquidity.

Finally, we ask about the effect of the number of analysts following the firm. Easley, Hvidkjaer, and O'Hara (2002) suggest that information asymmetry may be a priced risk factor. Consistent with their hypothesis, Easley et al. find that stocks with higher probabilities of information-based trading have higher rates of return. A wider analyst coverage is likely to correspond to a better availability of information about the firm and hence to less information asymmetry. Bowen, Chen, and Cheng (2007) find that wider analyst coverage is associated with lower underpricing of seasoned equity offerings, consistent with the joint hypothesis that information risk is priced and analyst coverage is a proxy for this risk. However, Chordia, Subrahmanyam, and Anshuman (2001) find little role for analyst following in explaining future returns.

3. Results

3.1. Required returns -mode

Do advisors require a risk premium to hold stocks with characteristics associated with risk? Table 1 shows the proportion of advisors who require a return premium for each of the four characteristics. The majority of advisors do require a return premium for all of the characteristics. Almost ninety percent require a premium for holding less liquid stock, consistent with e.g. Amihud and Mendelson (1986) and Pastor and Stambaugh (2001) in that the return requirement on an asset is negatively correlated with liquidity. Higher leverage also causes an increased return requirement for the overwhelming majority of advisors. Perhaps surprisingly, value stocks command a return premium as well: almost four out of five advisors required extra return for holding stocks with inferior growth prospects. Slightly over half of the advisors require a return premium from stocks with less analyst coverage.

3.2. *Expected returns -mode*

The outcomes change dramatically when we move from asking about required returns to asking about expected returns. Table 2 shows that only a small minority of advisors expect higher returns due to the same four characteristics that were associated with an extra return requirement in the other experimental mode. The return requirement therefore does not translate into a higher return expectation.

In three out of four characteristics the majority of advisors even expects lower returns for bearing risk. This is the case for leverage, which is against the CAPM and the empirical evidence of Bhandari (1988) and Fama and French (1992). Similarly, investment advisors expect outperformance from stocks with good growth prospects, measured by analysts' consensus earnings growth expectations. As many as 93% of the respondents see companies with better than average growth prospects as providing better than average returns. We know from La Porta (1996) that these expectations are not met. Note that 78% of the respondents in the other experimental mode said that in order to invest in a company that has worse than average growth prospects, they would require higher than average return on investment.

The majority also expects stocks with poor liquidity to have lower expected returns. This is again inconsistent with the empirical evidence on realized returns (e.g. Amihud and Mendelson, 1986). Moreover, advisors were most unanimous in their return requirement regarding liquidity: 89% state that they would require higher return in compensation for poor liquidity in the other experimental mode. However, in this mode only 7% agree with the proposition and instead 70% expect lower returns from less liquid companies compared to more liquid but otherwise similar companies.

In sum, advisors expect higher leverage, poorer growth prospects, and less liquid stock to lead to lower returns. The majority expects no effect on returns due to less analyst following, but

even in that case a clearly higher portion of respondents expects lower returns rather than higher returns. At the same time, the majority of advisors associate all of these characteristics with risk and require extra returns for bearing that risk in the other experimental mode. Figure 1 summarizes the results of the two experimental modes by showing the proportion of respondents requiring a return premium, and, on the other hand, the proportion expecting a higher return.

We have argued that based on current knowledge, the four characteristics can plausibly be thought of as priced risk factors. The grounds for such a view seem to be the strongest in the case of higher leverage, relatively strong in the case of poor growth prospects and illiquid stock, and perhaps the weakest in the case of analyst following. Some advisors might still, however, consider a lower return requirement given the characteristics. Expressing such a view was not possible in the survey, as the respondents could only indicate whether they would require a higher return (yes or no). To reflect this asymmetry, Figure 2 compares the proportion of those who do not require a return premium to the proportion of those who do not expect higher returns (i.e., those who expect either a lower return or no effect on returns). Using this alternative comparison, the discrepancy between return requirements and expectations is still huge.

In the expected returns mode investment advisors thus seem to think that good companies are good investments, consistent with the findings of Shefrin and Statman (1995), La Porta, Shleifer, and Vishny (1997) and Shefrin (1999). The advisors may form a negative association between risk and return and as a consequence end up expecting higher returns from less risky stocks. This can be seen as an application of the representativeness heuristic (Tversky and Kahneman, 1974).

3.3. The effect of the level of expertise

Several studies have shown that behavioral biases decrease with expertise (see e.g. List, 2003). We use education as a proxy for expertise to test whether the expertise of an investment advisor changes the effect of framing. We calculate the responses in the expected return mode by dividing the respondents into those with a college degree, and those without one. The results are shown in Table 3. The better educated advisors seem to subscribe slightly less to the “good company equals good investment” –adage. This is true in all of the four firm characteristics. Nevertheless, the differences are small, and statistically (borderline) significant only in one case: the college educated advisors more often expect low analyst coverage to lead to higher returns. However, using the proportion of those who expect a lower return, the difference is not statistically significant. In unreported results we also compare the college-educated and the rest of the respondents in the required return mode. The differences there are very small and statistically insignificant.

We also investigate the subgroup of advisors who have passed both of the FASD examinations, whereas the analysis up to this point has required only the first level examination. There are 81 such respondents in the expected return mode. Their expectations also go in the same direction with the base sample. However, a smaller proportion of them associate higher leverage (61% vs. 68%) or poor liquidity (53% vs. 70%) with lower returns compared to the base sample. The answers are similar to the base sample regarding growth prospects and analyst following. As a further robustness check we limit the analysis to college graduates with a Master’s degree. The results are similar.

The fact that the survey was conducted with Finnish financial advisors may raise the question as to what extent these results generalize to other populations of financial market professionals. Several reasons suggest good prospects for generalizability. First, based on the

analysis reported in this section, we do not believe the effects to vary greatly as a function of the respondents' sophistication. Casual conversations with bank executives and portfolio managers suggest similar effects might be encountered in these groups as well, but testing this conjecture is left for further work. Second, Finland is a developed environment. It has maximum points on both the 'Efficiency of judicial system' and 'Rule of law' measures of La Porta et al. (1998) and is the least corrupt country in the world according to Transparency International. The Programme for International Student Assessment (PISA) in 2006 ranks Finnish schoolkids as the best in the world (out of 57 countries) in science, and as the second-best in reading proficiency and mathematical literacy. Third, as mentioned, the results in the expected returns mode are in line with earlier studies conducted on other subject populations, such as senior executives and financial analysts.

4. Conclusion

Consistent with La Porta et al. (1997) and Shefrin (1999), investment advisors seem to perceive good companies as good investments that provide superior returns. However, the result depends on how the question is framed – whether the question is posed in terms of required return or expected return. For example, 86% of the advisors require a risk premium for investing in highly leveraged stocks, but only 13% of the advisors expect such stocks to provide higher returns. Furthermore, an overwhelming 68% expect them to provide lower returns. Limiting to relatively more sophisticated advisors does not change the conclusions.

While the results of this study do not prove that investment advisors give inconsistent advice to their clients, the results do however indicate that the advisors are perceptive of unconsciously doing so. The implications can be severe in the field of investment advising. Given that leverage, growth prospects, liquidity, and analyst coverage are all well-known firm

characteristics with a certain effect on the risk of an investment, the effect of the manipulation is surprisingly strong. The fact that clients may ask the same question in different ways means that the effect of framing can be important in actual client conversations as well. The results imply that situational factors can influence the advice that a client receives from a professional.

The type of inconsistent expectations, as documented in this paper, may contribute to the overpricing and subsequent inferior performance of glamour stocks: requiring less of a risk premium for these stocks boosts current prices, but at the same time expecting extra return sets the stage for disappointments in the future. The same inconsistency may operate in the time series of aggregate market expectations as well: high prices and higher return expectations go together, as documented by Vissing-Jørgensen (2003).

It is widely accepted that individual investors are subject to behavioral biases leading to investment mistakes. The biases could be corrected and mistakes avoided with the help of a qualified financial advisor. In fact, avoiding investment mistakes is one of the leading reasons for using the services of financial advisors (Fischer, Jansen, and Hackethal, 2008). However, the value added from advice is compromised if the advisors are subject to the same biases as the individual investors are. Giving consistent advice is a necessary condition for providing valuable client service, which is clearly in the interest of financial institutions.

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Table 1
Required returns –mode

The respondents are Finnish financial advisors who have passed a voluntary self-regulatory exam.

All other things equal, would you require a higher return if the firm has...

	Yes	No
higher leverage	86.2 %	13.8 %
poorer growth prospects	77.7 %	22.3 %
less liquid stock	89.3 %	10.7 %
less analyst following	52.4 %	47.6 %
N	168	

Table 2
Expected returns –mode

The respondents are Finnish financial advisors who have passed a voluntary self-regulatory exam.

All other things equal, would you expect the stock to provide higher returns, lower returns, or no effect if the firm has...

	Higher return	Lower return	No effect
higher leverage	12.5 %	68.2 %	19.3 %
poorer growth prospects	1.9 %	93.0 %	5.1 %
less liquid stock	7.3 %	70.1 %	22.6 %
less analyst following	14.9 %	25.7 %	59.4 %
N	314		

Table 3**Expected returns –mode, by respondents' education**

The respondents are Finnish financial advisors who have passed a voluntary self-regulatory exam.

All other things equal, would you expect the stock to provide higher returns, lower returns, or no effect if the firm has...

	College degree	Higher return	Lower return	No effect
higher leverage	Yes	13.3 %	64.5 %	22.3 %
	No	11.2 %	72.7 %	16.1 %
poorer growth prospects	Yes	2.4 %	92.9 %	4.8 %
	No	1.4 %	93.1 %	5.6 %
less liquid stock	Yes	8.9 %	64.9 %	26.2 %
	No	5.6 %	76.4 %	18.1 %
less analyst following	Yes	19.0 %	23.8 %	57.1 %
	No	10.3 %	28.3 %	61.4 %
N	Yes	168		
	No	145		

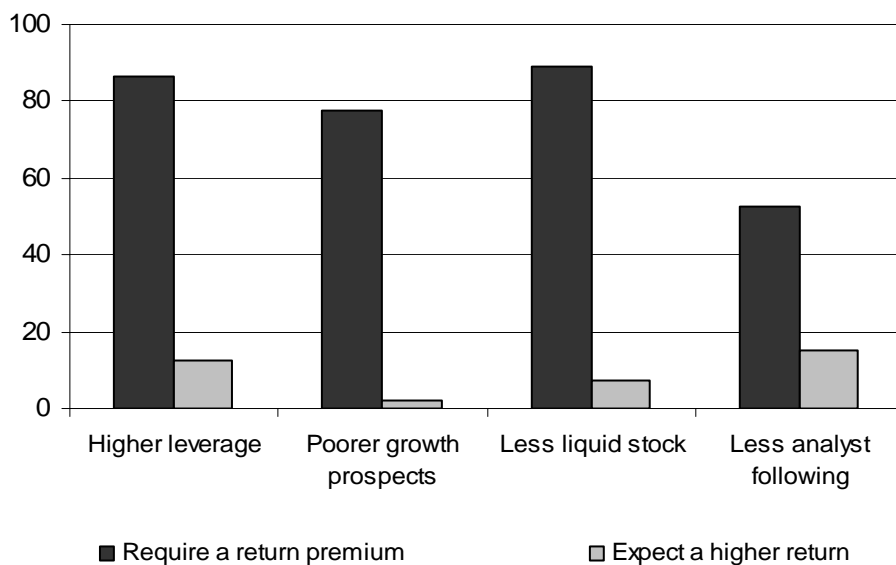


Figure 1. The black column shows the proportion of financial advisors who would require extra return from holding a stock with the said characteristic. The gray column shows the proportion of advisors who expect a higher return from a stock with the said characteristic.

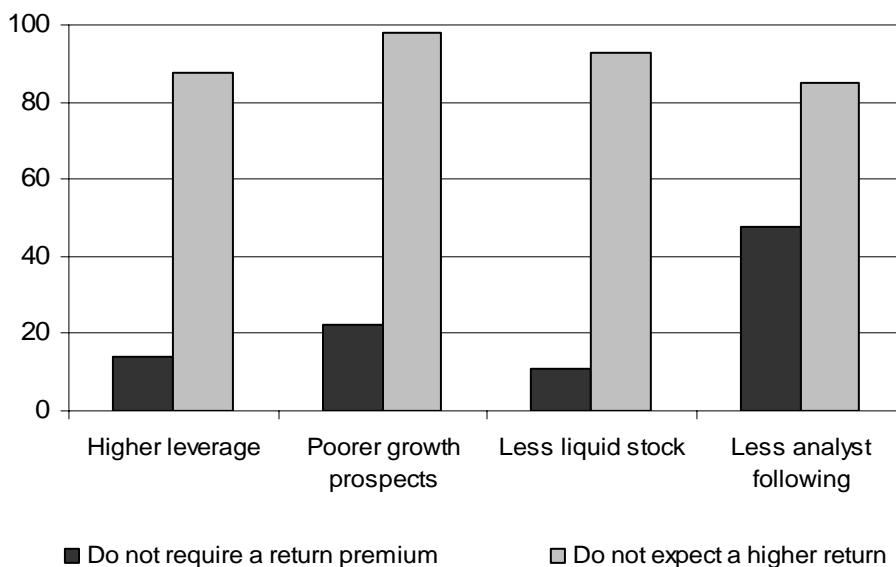


Figure 2. The black column shows the proportion of financial advisors who would not require extra return from holding a stock with the said characteristic. The gray column shows the proportion of advisors who do not expect a higher return from a stock with the said characteristic (i.e., expect either lower return, or that the characteristic has no effect on the return expectation).