

CHAPTER II

THEORETICAL FRAMEWORK

2.1 Literature Review

2.1.1 Stock

Stock is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings (BEI, 2011). The stock of a corporation is partitioned into shares, the total of which are stated at the time of business formation. Additional shares may subsequently be authorized by the existing shareholders and issued by the company. In some jurisdictions, each share of stock has a certain declared par value, which is a nominal accounting value used to represent the equity on the balance sheet of the corporation. Shares represent a fraction of ownership in a business. A business may declare different types of shares, each having distinctive ownership rules, privileges, or share values. Ownership of shares may be documented by issuance of a stock certificate. A stock certificate is a legal document that specifies the number of shares owned by the shareholder, and other specifics of the shares, such as the par value, if any, or the class of the shares.

When investing in stock market, an investor has the juridical characteristics as follows:

- a. Limited risk, investor only responsible until the amount deposited to the company
- b. Ultimate control, investor can decide the directions and objectives of the company through the mechanism of general meeting of shareholders or RUPS (Rapat Umum Pemegang Saham)
- c. Residual claim, investor is the last party that gets revenue sharing from the company (in the form of dividends) and the rest of the assets in the process of liquidation of the company.

According to Jogiyanto (1998) in the stock market there are two types of stocks most commonly known to the public, the common stock and preferred stock.

a. Common stock

Most of the outstanding shares in the stock is a common stock. The owners of these shares will receive a dividend if the company makes a profit and at the general meeting of Shareholders or RUPS (Rapat Umum Pemegang Saham) to agree on the distribution of dividends. If at any time the company is liquidated or goes bankrupt, holders of ordinary shares will receive the rights to the rest of the company's assets last after all liabilities or debts on the other hand have been paid.

b. Preferred stock

This type of stock distributes the dividend to its shareholders with certainty. If at any time the company is liquidated or goes bankrupt, this preferred

shareholder will receive rights to the rest of the company's assets before common stockholders. Generally, the amount of dividend distributed to holders of this kind of preferred stocks are already established.

2.1.2 Value Stock

Benjamin Graham and David Dodd (1934) suggests that stocks are not desirable and sometimes underpriced in the market capable of generating high returns. This investment paradigm then known as value investing (investing in stock value). Generally, value stocks are stocks that have a low price (underpriced) relative to the fundamental variables. The features of value stocks (value stocks) are stocks that have a value price-to-earnings ratio, price-to-book or price-to-cash flow ratio is low (Graham and Dodd, 1934). While the exact opposite of the stock value (value stocks) is a glamor stock, which shares that have the opposite characteristics of the stock value (Graham and Dodd, 1934; Damodaran, 2006).

Piotroski (2000) describes some of the characteristics of the value stock. First, value stocks tend to be preferred by the majority of investors, both individuals and institutions. Secondly, it is not easy to find information where appropriate stock value. Third, value stocks tend to be stocks that are experiencing financial difficulties. While Fama and French (1992), classifies glamor stocks are stocks that have P / E ratios, PBV, the P / C ratio, and size are high. In addition, glamor stock also has a dividend yield and return on equity that are low.

It has been suggested that the value stock strategy capable of generating superior returns, but the cause of the opinion is still very controversial. According to Fama and French (1998), the level of average returns of value stocks reflects compensation of a higher risk than value strategies. Lakonishok, Shleifer, and Vishny (1994) propose an alternative explanation based on the calculation of hypothesis, where investors make calculation to the past performance of stocks. La Porta (1996) suggested investors to sell stocks with high earnings growth and buy stocks with low projected earnings growth with excess returns. His research provides empirical evidence of the influence of earnings growth introduced through the price-to-earnings growth (PEG) ratio, which is a valuation tool that is widely used by the analysts. Peters (1991) calculated the PEG portfolios and found that low PEG quarterly rebalanced portfolios produce better results than high PEG quarterly rebalanced portfolios during 1982-1989 in the American market.

The analyst believes, the causes of value stock strategy can generate high returns are due as compensation for the risks faced by the value investor. Value investors apply a contrarian strategy or "naïve strategy" for this strategy foresees revenue growth of a company in the past into the future. This strategy aims to assume the trend in share prices in the future and find a good company that is not reflected by the company's stock price (Elze, 2010).

2.1.3 Glamor Stock

The stocks are called glamour stocks when they attract a large number of investors because of the significant price increase on a sustained period of time (Financial Dictionary, 2005). The price increase occurs because the income growth is higher than the industry average, which is why the glamour stocks are also referred to as growth stocks.

Damodaran (2006) classified glamour stocks with the opposite characteristics of the stock value. Glamour stock has price to earnings, price to book value, price to cash flow, and size that are high. In the stock market, there are several characteristics of Value stock shares and Glamour stock. Characteristics of these stocks can be seen through analysis fundamental approach to Price Earnings Ratio (PER) or Price to Book Value (PBV). PER approach can be used to determine Value-Glamour stock (Hasnawati, 2010).

2.1.4 Risk and Return

The main problem facing every investor is to determine which risky securities to be purchased. Because the portfolio is a collection of securities, and the issue for investors is similar to choosing the optimal portfolio of an existing portfolio.

To anticipate the problem, then it made attempt to minimize losses to the investment portfolio. Investors who do usually not on the capital market instruments,

but combined with other capital market instruments. Or we can say, is a set of investment portfolio or a combination of two or more securities. The main purpose of this combination is the safest investment plans with maximum benefit and minimal risk.

The measures suggested by John Dickinson (1974: 6) in performing portfolio, namely:

a. Placement analysis

In this step, the investor collecting data, both quantitative and qualitative of various investment tools that will be used as a portfolio

b. Portfolio construction

In this step, investors began to perform a variety of investment tools to meet their investment objectives

c. Portfolio selection

In this step, the investors began to selecting the portfolio that is suitable from the previous research

2.1.5 Price to Earnings Ratio (PER)

Rational factors that affect the decision of investors to buy stocks in general related to analysis fundamental. Investor analyzing financial statements using financial ratios, one approach is to use PER (Elze, 2010).

According to Darusman (2012), Price Earnings Ratio is the ratio of the market price per share (market price per share) to earnings per share (earnings per share). The function of the PER is to see how the market appreciates the shares of a company's performance against the performance of the company reflected by EPS.

$$PER = \frac{MPS}{EPS}$$

Which is:

PER = Price Earnings Ratio

MPS = Market Price per Share

EPS = Earnings per Share

PER research conducted by Truong (2009), found the PER has a negative correlation with the return. PER is low can result in higher stock returns compared with stocks that have a high PER. The research was conducted on the New Zealand Stock Exchange in the period 1997-2007.

According Suhardiah (1996) companies that have a low PER reflects pessimistic on the stock market so that investors pay less attention (neglected) shares and tend to undervalue the price of its shares.

The stock selection strategy by using the PER is not without drawbacks. Stock selection using PER as a reference investment may lead to bias in digesting the information that has been published. This is because the denominator of PER is EPS (earnings per share). By just looking at PER we will not know if there was a gain on sale of assets that catapulted EPS (eg the sale of the building). Asset sales generally only happens every few years. In addition, changes in exchange rates also result in losses as well as profits of the company. A company experienced a good year could look ugly because the losses are huge. Likewise, a large exchange rate gains will make the company look good even though its performance is declining (Parahita, 2012). However, the general strategy of stock selection based on PER eligible to be used as an investment tool.

2.1.6 Dividend Yield (DY)

Dividend yield is one of the indicators in measuring the company's dividend policy. Dividend yield is the ratio between the amounts of the dividend per share paid to shareholders compared to the price per share for the period (Fabozzi, 2003).

Dividend yield provides a measure of total return component generated dividends, by adding the existing price appreciation. Some investors using dividend yield as a measure of risk and investment as a filter, that they will try to invest in stocks that generate a high dividend yield.

2.1.7 Return on Equity (ROE)

Return on Equity (ROE) is a tool used by investors and top management of companies to measure how much profit can be made from the company's own capital. From the investor side, ROE is used to measure the benefits of the investments made. In terms of management of the company, this analysis is very important because it is a pull factor for investors to make an investment to the company (Hirt, 2006).

According Darusman (2012), Return on Equity is also called the return on equity or in some references referred to as the ratio of total asset turnover or total asset turnover. This ratio examines the extent to which a company uses its resources to provide benefits on equity. Understanding Return On Equity according to Van Horne and Wachowicz (2005) is to measure the ratio of net profit after tax with its own capital.

Thus, this ratio connects between the net profit after tax obtained from the company's operations with its own capital amount owned. The higher the ROE, the company has the opportunity to provide income for shareholders.

Based on previous research conducted by Jenn Yaw Yen et al (2002), Elze (2010), Darusman (2012) concluded that one of the characteristics of value stocks are stocks that have a high ROE value. Values higher ROE in the long-term impact on the stock price increase.

2.1.8 Return Portfolio

According Fabozi (2003), portfolio theory that deal with choosing the portfolio that can maximized the expected return suitable with the risk portfolio taken. The portfolio can be developed with a quantitative approach and historical data to produce the expected portfolio return and measure the level of risk is acceptable.

In the establishment of a portfolio, investors are trying to maximize the expected return on investment with a particular risk is acceptable. In other words, investors are trying to minimize the risks facing specific to the target rate of return. Portfolio that goes accordingly as described above is called the efficient portfolio (Husnan, 1996).

2.1.9 Measurement of The Return Portfolio

There are several ways of comparing portfolio returns with each other and with the market in general. A simple comparison is to simply compare their returns.

However, returns by themselves do not account for the risk taken. If 2 portfolios have the same return, but one has lower risk, then that would be the preferable, more efficient portfolio.

There are 3 common ratios that measure a portfolio's risk-return tradeoff: Sharpe's ratio, Treynor's ratio, and Jensen's Alpha.

a. Sharpe's Ratio

According Tandelin (2001) Sharpe measurement method is a method of linking the level of total return with the risk level where the total risk is dominated by systematic risk. This method can be used on a portfolio in which no systematic risk can be eliminated by diversification. Measurements by this method to adjust the level of risk (risk adjusted measure) the performance of the portfolio, known as Reward to Variability Ratio or RVAR.

Assumed risk-free investment is an investment in Bank Indonesia Certificates (SBI). Because of the risks that arise when investing, stock portfolio is expected to provide a larger return than the risk-free investment performance. Standard deviation is a method used to measure the total risk (systematic risk and unsystematic risk) faced by the Investment Manager (Jogiyanto, 1998). This method measures how much the return obtained for each of the risks taken. Therefore, the higher the value of this ratio indicates improvements in the performance of the portfolio (Jogiyanto, 1998).

b. Treynor's Ratio

While the Sharpe ratio measures the risk premium of the portfolio over the portfolio risk, or its standard deviation, Treynor's ratio, popularized by Jack L. Treynor, compares the portfolio risk premium to the systematic risk of the portfolio as measured by its beta.

Jack L. Treynor was the first to provide investors with a composite measure of portfolio performance that also included risk. Treynor's objective was to find a performance measure that could apply to all investors, regardless of their personal risk preferences. He suggested that there were really two components of risk: the risk produced by fluctuations in the market and the risk arising from the fluctuations of individual securities.

c. Jensen's Alpha (Jensen Index)

Alpha is a coefficient that is proportional to the excess return of a portfolio over its required return, or its expected return, for its expected risk as measured by its beta. Hence, alpha is determined by the fundamental values of the companies in the portfolio in contrast to beta, which measures the portfolio's return due to its volatility. Jensen's alpha (aka Jensen index), developed by Michael C. Jensen, uses the capital asset pricing model (CAPM) to determine the amount of the return that is firm-specific over that which is due to market volatility as measured by the firm's beta in relation to the market beta.

Jensen's alpha can be positive, negative, or zero. Note that, by definition, Jensen's alpha of the market is zero. If the alpha is negative, then the portfolio is underperforming the market; thus, higher alphas are more desirable.

In this study, the researcher decided to use the Sharpe ratio to measure performance because the risk adjusted Sharpe ratio method is able to compare the performance of the assets with other assets (return on risk-free investments from SBI). In addition, this method is also relatively easy to calculate. In the Sharpe ratio, there are no standardized criteria to measure how well the value of the Sharpe ratio, but in this study, assumes that the value of a good Sharpe ratio is a value higher than KOMPAS100.

2.1.10 Consistent Earner Strategy

Consistent Earner strategy is the formation of portfolio strategy based on a combination of fundamental analysis variables with a variable return on capital (capital return variable) (Elze, 2010). The fundamental variables include price-to-earnings ratio (PER), dividend yield (DY), price-to-book value (PBV), price-to-cash flow (P / C), and others. While included in the variable return on capital is the return on equity (ROE), return on investment (ROI) and return on asset (ROA). In this study using a combination of fundamental variables PER and DY and variable capital return ROE as a basis for the establishment of a portfolio.

Portfolio of consistent earner strategy is then classified into stock portfolio value and glamor stocks portfolio. Value stock portfolio comprised of stocks that have a low PER value and high ROE and the portfolio has a value of high DY and high ROE. While the glamor stock portfolio comprised of stocks that have the criteria in contrast to the stock value.

2.2 Previous Research

Research conducted by Elze (2010), which examines the phenomenon of value stocks outperform glamour stocks on the European Stock Market. This study uses data sampling on July 1, 1994 until June 30, 2009. This study uses a variable P / E ratio, P / B Ratio, DY, ROE, Levy27, and M03m, which is incorporated into the portfolio strategy formation single value, multiple value, consistent Earner, and Recognized value. Results from these studies are value stocks outperform glamor stocks in European Stock Market in the study period. This study found that a good strategy single value, multiple value, consistent Earner, and Recognized value is able to generate a higher return than glamour stocks.

Jenn Yaw Yen et al. (2002) examined the value stocks and growth stocks in Singapore. They tested the share premium value (premium value) for five years after the establishment of the stock portfolio value and glamor. This study uses a variable P / E, P / B and ROE in determining stock portfolio. After the formation of the portfolio,

the portfolio risk level was tested by using CAPM. The results of these studies found that there is a premium value on the Singapore Stock Exchange that is concentrated in the first two years after the formation of the portfolio.

La Porta (1996) advised investors to sell stocks that have high revenue forecasting and buying stocks that have low revenue forecasting. The results of this study obtained after classifying stocks in the US Stock Market during the period 1982-1989 into stocks that have a good past performance and past performance is bad. The study found that stocks that have poor past performance (having a low-income forecasting) outperform stocks that have a good past performance (has a high revenue forecasting).

Research by Hasnawati (2010) test on the stock portfolio value and glamor stocks using price earnings ratio (PER) for the period 2003-2007 the Indonesian capital market and to test each of the risk of the portfolio selection. The results of the other research states that the stock portfolio value does not generate a higher return than the return of glamor stock portfolio. This finding contrasts with previous studies.

Table 1
Summary of Previous Research

No	Research Titles	Research Variables	Results
1	Value Stocks Anomalies in The European Stock Market: Multiple Value, Consistent Earner, and Recognized Value (Elze, 2010)	P/E Ratio, P/B Ratio, DY, ROE, Levy27, and M03m	Single value strategy, multiple value strategy, consistent Earner strategy, and Recognized values strategy able to generate a higher return than glamour stock.
2	Value Versus Growth Stock in Singapore (Yen, Sun, and Yan, 2004)	P/E, P/B, and ROE	There is a premium value on the Singapore Stock Exchange that is concentrated in the first two years after the formation of the portfolio.
3	Expectations and Cross-section of	PER	Stocks that have a poor past performance

	Stock Returns (La Porta, 2006)		(having a low-income forecasting) outperform stocks that have a good past performance (has a high revenue forecasting).
4	The Value and Glamor Stocks Performance at The Indonesia Stocks Exchange Using the Price Earnings Ratio Approach (Hasnawati, 2010)	PER	Value Stock Portfolio does not generate a higher return than the return of glamor stock portfolio. This finding contrasts with previous studies.

2.3 Research Hypothesis

Based on the explanation from the background, the theoretical frameworks, and empirical results of studies on the various capital market of the world, the following hypothesis are formulated:

- a. Consistent earner strategy is an investment strategy that combines accounting ratios (PER and DY) with ROE, which acts as a variable capital return. The use of this strategy can perceive the stock based on the advantages of the investor (PER and DY) can also see the advantages of the company (ROE) in the selection of investments in shares (Elze, 2010).

The formation of the portfolio will be classified into the value and glamor by category as follows: stock that have a low PER and high ROE will be classified into value stock, while stock that have a high PER and low ROE will be classified into a glamor stock.

Research by Elze (2010), found that the portfolio value based on the stock selection consistent earner strategy in general produces a negative return in one year after the formation of the portfolio will however generate positive returns and exceed the return of glamor stocks in subsequent years during the observation period 1994-2008 in European capital market.

H₁: Portfolio value stocks provide higher return than the portfolio of glamor stocks.

- b. Research by Kargin (2002) about “Value Stocks in Emerging Market: Risk and Benefits” found that investing in value stocks (value stocks) returns that exceed the returns of the stock glamor and give a greater risk than the stock glamor. This risk is compensated by the return received by investors who expect a high return. This is in accordance with the law of investment "high risk, high return".