Retained Earnings as a Determinant of the Cross Section of Returns 2006-2014

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Study Objectives
1. Determine if retained earnings is a priced in factor in the cross section of returns
2. Determine if a combination of price and retained earnings weighted portfolios outperformed their benchmarks

Research Approach
1. Sort S&P 500 into deciles of 50 stocks by firm size
2. Divide top 50 stocks by size into 2 portfolios of 25 stocks each based on price to book
3. Utilize 3 portfolio weighting strategies
   a) Price Weighted
   b) Retained Earnings per Share Weighted
   c) Combination of Price and Retained Earnings per Share Weighted Portfolios

Model Specification
1. **Price Weighted**
   \( (P_{w_i}) = P_i / (\sum P_i / N) \)
2. **Retained Earnings Weighted**
   \( (RE_{w_i}) = RE_i / (\sum RE_i / N) \)
3. **Combined Weighted**
   \( (C_{w_i}) = .5P_{w_i} + .5RE_{w_i} \)

Hypothesis
- \( P_{w_i} \) outperforms benchmark
- \( RE_{w_i} \) outperforms benchmark
- \( C_{w_i} \) outperforms benchmark

Findings:
- LCG – All weighting models generated alpha. RE had highest alpha
- LCV – All 3 weighting models generated alpha. Price Weighted had highest alpha
- Rebalanced – LCG: all 3 models outperformed. RE had highest alpha
  LCV: Price and combined weighted outperform while RE does not

Conclusions:
- Retained earnings appears to be priced-in factor for growth portfolios but not for value portfolios