4-9-2016

Do High ROE Stocks Outperform the Market with Persistence: An Empirical Analysis, 2009 - 2014

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Study Purpose: to determine if ROE is a predictor of stock excess returns

Research Design: establish portfolios of high (40%) and low (5%) ROE stocks and compare their returns to the S&P 500 (SPY)


The Model:
\[ R_{t+1} = f(ROE_t), \]
where: \( R_{t+1} \) = return to ith stock at \( t + 1 \)
\( ROE_t \) = return on equity for ith stock at time \( t \)

Hypotheses:
(1) High ROE stocks outperform the market
(2) High ROE stocks outperform low ROE stocks

Data Analysis: Table 1
(1) High ROE stocks outperform SPY in all 5 years
(2) High ROE stocks generate strong alpha in the trading range year 2011 and the growth year 2013

Data Analysis: Table 2
(1) On a cumulative basis, high ROE stocks generate $5 million dollars of alpha based on an original investment of $10 million

Data Analysis: Table 3
(1) Low ROE stocks have negative alpha in 3 of the 5 years
(2) Positive alpha was generated in the rebound year 2010 and the growth year 2013

Data Analysis: Table 4
(1) On a cumulative basis, low ROE stocks generate $673,467 of excess returns on an original investment of $10 million

Conclusions:
(1) High ROE stocks outperform the market
(2) High ROE stocks outperform low ROE stocks
(3) During the 2010 – 2014 period, both high and low ROE stocks generated excess dollar returns