

Firm profitability and expected stock returns: Evidence from Latin America

Abstract

Despite their higher valuation ratios, larger size, and higher investment needs, profitable firms outperform, in both raw and risk-adjusted returns, unprofitable firms in Latin America. The positive effect of firm profitability on stock returns is pervasive in univariate and bivariate sorts, panel regressions, across sub-regional markets, and among small and large stocks. A five-factor model that includes market, size, distress, profitability, and investment factors prices profitability portfolios better than other popular factor models. Five-factor alphas of profitability portfolios tend to be lower and less statistically significant, both individually and collectively, than alphas from other three widely-used pricing models.

JEL Classification: G11; G12; G15

Keywords: operating profitability; cross-sectional returns; five-factor model; Latin America

1. Introduction

Several recent papers focusing on the U.S. stock market have analyzed the impact of firm profitability on the cross-section of stock returns. Novy-Marx (2013) finds that gross profitability (i.e., gross profits over assets) has a positive and significant predicting power in the cross section of returns beyond value, size, and momentum effects. This finding is difficult to reconcile with previous evidence by Fama and French (1993) in which the HML factor absorbed time variation of relative earnings in a setting where low book-to-market (BM) firms showed high (not low) and persistent earnings while high BM firms showed the opposite. Ball, Gerakos, Linnainmaa and Nikolaev (2015) find that operating profits (i.e. gross profits minus selling, general, and administrative (SGA) expenses, but excluding research and development expenditures) better predict future returns than gross profits. Thus, operating profitability, instead of gross profitability (as suggested by Novy-Marx (2013)), becomes a cleaner measure of economic profitability. Noise (when predicting returns) derived from the arbitrary accounting allocation of costs between costs of goods sold (COGS) and SGA appears to dilute when both COGS and SGA are combined in an operating profitability measure. In a subsequent paper, Ball et al. (2016) document that cash-based operating profitability has a positive and significant effect on monthly returns and that the cash-based profitability measure subsumes the effects of other profitability

variables like operating profits or accruals on stock returns. In all, monthly returns appear more closely related to the operating cash generated by the firm than to operating profits that involve accounting accruals adjustments. More recently, Novy-Marx (2016) find, after controlling for a new factor related to profitability, in addition to the three Fama French factors (market, size, and distress), that the abnormal returns to defensive strategies (e.g. those that take long and short positions in low beta (volatility) stocks and high beta (volatility) stocks, respectively) are no longer significant. As an illustration, consider the case of the poor performance of highly volatile stocks. This underperformance derives from the fact that high volatility stocks usually come from small and growth firms with low operational profitability. After accounting for the low profitability of highly volatile stocks, their poor returns are no longer unexpected. Extending the evidence to international markets, Sun, Wei, and Xie (2014) test for a profitability effect (using gross profits over assets as a proxy of firm profitability) on stock returns using a sample of developed and developing countries. On the whole sample, they find a positive effect of profitability on returns. Nevertheless, the effect appears confined to developed markets. Only a handful of developing countries showed a significant and positive effect of profitability on stock performance.