A Weak Link Between ROE and High Returns

A popular measure of profitability, return on equity (ROE), does not hold up well as a primary screening criterion for identifying stocks with potential upside.

The ratio divides net income by shareholder equity. It reveals how much profit a company is earning of off its net assets. The more effectively management uses the company's resources, the higher ROE will be. It is said to be a favored indicator of Warren Buffett.

Given this, it would seem logical that ROE would be a useful ratio for identifying stocks likely to outperform in the future. Yet, ROE may work better as an indicator of risk than of potential return. This is the finding of two books: "What Works on Wall Street, Fourth Edition" by James O'Shaughnessy (McGraw-Hill, 2012) and "Quantitative Strategies for Achieving Alpha" by Richard Tortoriello (McGraw-Hill, 2008). Both authors say only stocks with ROE ratios ranking in the top 20% enjoyed clear outperformance.

What was more significant was the performance of the stocks with ROE ratios ranking in the bottom 20% of all companies. These companies lagged significantly. The margin of their underperformance was far greater than the margin by which companies ranking in the top quintile for ROE ratios outperformed. The average excess returns were -9.6% and 6.2%, respectively, according to Tortoriello. Using a different database and longer time period, O'Shaughnessy calculated average annual excess compound returns of -3.9% and 1.0% respectively.

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