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Financial ratios used by equity analysts in Mexico and stock returns

Razones financieras usadas por analistas del mercado de capital en México y rendimiento de acciones

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Abstract

A sample of recommendation reports by equity analysts covering Mexican publicly traded firms in Mexico is studied. We propose a set of "most preferred" financial ratios from this sample. It is found that the most preferred ratios by equity analysts, a group of sophisticated users, are not those ratios typically covered in financial textbooks. Moreover, by using panel regression analysis, we test the relationship between financial ratios and leading stock returns during the 1995–2011 period. Overall, consistent with the efficient market hypothesis, the results show that estimates of financial ratios most preferred by equity analysts have predictive power on 1-year future stock returns. We find no evidence of predictive power on 2-year stock returns.

Keywords: Financial ratios; Equity analysts; Mexican firms; Panel regression

Resumen

Se estudia una muestra de recomendaciones por analistas del mercado de capital en México. Proponemos un grupo de razones financieras "preferidas" en base a esa muestra. Encontramos que las razones financieras preferidas de los analistas, un grupo sofisticado de usuarios de información financiera, no son aquellas

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típicamente incluidas en los libros de texto de finanzas. Más aún, usando análisis de regresión de panel, probamos estadísticamente la relación entre razones financieras y rendimientos futuros de acciones durante el periodo de 1995–2011. En general, en consistencia con la hipótesis de mercados eficientes, los resultados muestran que los coeficientes de las razones financieras preferidas por analistas tienen capacidad predictiva sobre rendimientos futuros a un año. No encontramos evidencia de capacidad predictiva en rendimientos a dos años.

Palabras clave: Razones financieras; Analistas financieros; Empresas Mexicanas; Regresiones de panel

Introduction

The purpose of this article is twofold; to propose a set of "most preferred" financial ratios and to test the relationship between financial ratios and stock returns. We select sets of financial ratios from a sample of recommendation reports by leading equity analysts. Then, we test a model on which stock returns are regressed on financial ratios. Results are discussed in terms of financial theory.

Two sets of results are provided: (1) most preferred financial ratios by equity analysts in Mexico, and (2) econometric tests on the relation of financial ratios and future stock returns. Results of this study might be of importance for diverse users of financial ratios (e.g., academics, corporate managers, banks). The high number of financial ratios used in practice could confuse users due to overlapping information. Thus, a reduced set, selected from a group of sophisticated users (e.g., equity analysts), might be valuable by itself. This information set is additionally valuable for the predictive ability of the selected ratios.

Overall, our proposed sets of most preferred ratios have predictive power, and the estimators have the signs as predicted by theory; supporting the proposition that those ratios indeed represent a set of valuable financial information. By using results from this study, users could become more selective about the information to use for financial analysis. Equity analysts would be interested in which ratios were used by competitors and firms interested in which ratios were used by equity analysts, which could lead to improved decision making by both parties. Moreover, since the literature on the use of financial ratios is scarce and focused primarily on the US market, we contribute to the finance literature.

Literature review

A recurring research question has been whether financial ratios predict firm performance. Wang and Lee (2010) used financial ratio categories (leverage, solvency, turnover, and profitability) to create a matrix that provide an estimate of the strength of a firm within the shipping industry in Taiwan. Recently, in a similar study of the U.S. agricultural industry, Katchova and Enlow (2013) used the DuPont ratios to compare return on equity components of agribusiness firms, finding that asset turnover was the most predictive ratio, leading to a stronger financial performance. In general, financial ratios have been used as inputs to forecast a number of business related situations such as financial distress, credit ratings, risk, future cash flows, among others (Beaver, 1966; Call, 2008).