

CAN ROE BE USED TO PREDICT PORTFOLIO PERFORMANCE?

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Abstract

Return on equity (ROE) is a closely watched financial ratio among equity investors. It is a strong measure of how well the management of a firm creates value for its shareholders. Different financial ratios, for instance, Price-to-Book, Price-to-Earnings, Price-to-Sales, Debt-to-Equity, have been used to predict security performance. This study, using ROE to predict portfolio performance, found that investors can create portfolios based on a simple historical financial ratio, i.e., ROE, which will produce positive abnormal return without extensive cumbersome fundamental research. However, portfolios based on higher ROE do not guarantee higher positive abnormal return. This particular strategy could be very cost-effective in the emerging markets where financial data is not readily accessible.

Keywords: ROE, portfolio performance, management, firm, shareholder.

JEL Classification codes: G11.