

# **EPS : ITS FORECASTING**

**AND**

## **ITS RELATIONSHIP WITH STOCK RETURNS**

### **Abstract**

A survey of the way equity research is being done revealed that analysts mainly use the P/E approach (where they multiply the forecasted EPS with the forecasted P/E ratio) to forecast the stock prices. The analysts disclosed that the most difficult part of equity research is the largely unpredictable nature of P/E ratio. In fact some analysts consider a rigorous forecasting of EPS a futile exercise for according to them what matters is the correct prediction of stock prices and not EPS or P/E alone and as long as P/E ratio remains unpredictable, there is no point in forecasting the EPS rigorously.

The above response seems surprising because theoretically stock returns and earnings are strongly correlated. In fact some recent empirical work done abroad have found out a very strong correlation between earnings and stock returns. Hence the contention of the analysts that a rigorous forecasting of EPS is a futile exercise does not appear to be correct.

This thesis attempts to answer the question of whether excess return can be earned by forecasting EPS alone. Ou and Penman (1989) have shown that excess return can be obtained by forecasting the direction of movement of EPS in the US capital market. They developed a forecasting model using Logit and the model was able to yield excess return for a period of ten years (their total sample period).

A similar study done here for the Indian stock market shows that one can obtain excess return (defined as the difference between the portfolio return and both sensex return and the return on a buy and hold portfolio) by forecasting the direction of movement of the EPS and taking positions accordingly. Since the model needs information from the annual report of a company as inputs (which are publicly available information), this is suggestive of the fact that the market is semi-strong inefficient.

One can, however, obtain excess return by holding a risky portfolio. Hence risk adjustment needs to be done to see whether the excess return is coming from the riskiness of the securities or from one's ability in identifying undervalued stocks.

Arbitrage Pricing Theory (APT) explains total return as a function of the factor risk exposures of the stocks. Hence the APT serves as a good risk adjustment model because it explains the systematic risk of the stocks and hence any differential return can be attributed to the EPS forecasting model. However, it was found out that none of the factors seem to be priced in India. This may either mean that the sample size is too small to do any meaningful test of APT. It may also mean that the APT does not work in the Indian context.

There are many other measures and proxies for risk. They are beta, P-E ratio, size, and book to market ratio. It was observed that the excess return cannot be explained by any of the above risk measures. Hence one can make excess return in India by forecasting the direction of movement of EPS and this excess return cannot be explained away by any risk measures.