FACTOR/STYLE INVESTING

Parallels Between the Cross-Sectional Predictability of Stock and Country Returns

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Firm characteristics such as book-to-market ratio, market equity and one-year past return help explain the cross-section of average returns on U.S. stocks. In this paper, we find that the same characteristics can be used to help explain differences in expected returns among national equity markets as a whole.

First, country versions of book-to-market ratio, market equity and one-year past return (also known as momentum) help explain the cross-section of expected country returns. Second, the January seasonal effect in market equity's explanatory power for stocks also appears for countries. Third, portfolios formed by sorting stocks and countries on these variables produce similar patterns in profitability for stocks and countries.

Parallel evidence from stocks and countries bolsters the case that the observed book-to-market-, market equity- and momentum-related premiums are not a consequence of data mining.

In summary, we document country and stock parallels in the relation between the characteristics studied and measures of profitability. Across countries and stocks, low book-to-market and high market-equity portfolios produce consistently higher profits than high book-to-market and low market-equity portfolios. Moreover, patterns in profitability for momentum-sorted country portfolios are consistent with documented relations between profitability and returns for U.S. stocks.

While these results suggest that stock returns may be predictable, investors should interpret the evidence with caution.