



Equities

The Dynamic Relation Between Stock Returns and Key Financial Ratios

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It has been widely described that the value of a firm is determined by its profitability and growth. Profitability and growth are influenced by its product market strategy and financial market strategy.

This paper investigates how much variation of unexpected stock returns is explained by the variation of ratios related to the product market strategy versus by the variation of ratios related to the financial market strategy. The results of the paper show which strategy is more closely related with stock price variation than the other and its relative magnitude.

The empirical results show that the variance of news about asset turnover, which is a representative measure for a firm's product market strategy, is relatively more important in explaining the variation of unexpected stock returns than the variance of news about financial leverage, which is a measure for the financial market strategy. Indeed, product market strategy is nearly twice as related with unexpected stock returns variation than the financial market strategy in the overall sample.

On the other hand, industry analysis shows that the financial market strategy is more closely related with the unexpected stock returns variation than the product market strategy in manufacturing industry and others. If a firm becomes more capital intensive, the financial market strategy becomes more important relative to its product market strategy.

This paper contributes on the financial statement analysis research literature by providing an explicit link between stock returns and financial ratios within the present value relation framework.

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