Available online at http://scik.org

Mathematical Finance Letters, 2013, 2013:3

ISSN 2051-2929

REVIEW OF STOCK RETURNS

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Abstract: Growth in Capital expenditures also explicates returns to the portfolio and the cross section of future stock returns. Companies that substantially enlarge capital investments afterward achieve negative benchmark-adjusted returns. The negative capital investment and return relation observed stronger for firms that have greater investment prudence, i.e., firms that have higher cash flows and lower debt ratios, and is exposed to be considerable only in time periods when aggressive takeovers were less common. Firms that amplify capital investments supposed to have high past return and issue equity at the same time as the negative capital investment and return is free of the long term return reversal and secondary equity issue anomalies.

Keywords: Capital Investment, Capital Expenditure, Stock Return, Investment Expenditures, External financing, Capital markets.

2000 AMS Subject Classification: 91G99

1. Introduction

According to Sheridan Titman, K. C. John Wei, and Feixue Xie (2004) firms tend to invest more following increases in their stock prices, cash flows tend to be the best predictor of a firm's investment expenditures. Investment performance is a zero sum game: for every investor who beats the market, another under performances yet. In such a world we expect the skilled investors to gain and the unskilled to lose. Thus the under performance of the talented investment pros is baffling. Stock prices are likely to react favorably to the announcement of major capital investment. However, financing choices that are connected with amplified investment, such as equity issuances, usually outcome in negative stock returns while those options related with decreased investment, such as repurchases, normally result in constructive returns. There are number of reasons of viewing increased investment expenditures favorably.

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Received October 26, 2012

First, higher investment expenditures are likely to be associated with greater investment opportunities, second; higher investment expenditure that the capital market have greater confidence in the firm and its management. There are also findings of negative stock return from increased investment expenditures. For an example, managers have an incentive to put the best possible spin on both their new opportunities as well their overall business when their investment expenditures are especially high because of their requirement to raise capital as well as to justify their expenditures. If investors not succeed to appreciate managements' incentive to oversell their firms in these situations, stock returns succeeding to rise in investment expenditures are likely to be depressing. Sheridan Titman, K. C. John Wei, and Feixue Xie (2004) provides this outcome is likely to be particularly important for managers who are empire builders, and invest for their own profit rather than the benefits of the firm's shareholders

2. Literature Review and Discussion

The Role of financial markets is to efficiently allocate financial resources among competing uses and ultimately contribute to the production of real assets in the economy. Nikiforos K Laopodis, (2013) defines Real assets as the wealth of an economy where financial assets define the allocation of wealth among individuals. An investment in business may be obtained by subscribing for new shares, purchase of existing shares or purchasing the underlying businesses and assets (Damodaran, 2011). The choice depends on tax, legal and accounting matter, the necessities of the investee company and its shareholders and the structure that maximizes economic advantage for the acquirer's shareholders.

The intrinsic value of the investment to the investor will reflect this measurement of the amount and timing of the asset cash flows and is insight of the associated risks. The investor will not disburse more than this intrinsic value; it will also desire to minimize the risk that unanticipated future expenditure will be required to uphold the value of the investment. Above all, the investor will want to guarantee its shareholders advantage from the acquisition and that their returns are maximized. According to Chris f Agar (2005), the acquisitions of a majority shareholding will normally require payment of a control premium over and above the current market value per share for a

minority holding in the target, competently increasing the prosperity of the target's selling shareholders at the expenses of the acquirer's shareholders.

Capital investment is the attainment of a fixed asset that is predictable to have a long lasting use before being repaired or replaced. Two most common and easily recognizable examples of capital investments are buildings and land. Capital investment can be something as simple as a sum of money that is put aside in some kind of interest bearing account. Since the resource is not being used to cover business expenses, capital assets of this type is free of charge to be used for the purpose of generating added revenue by mounting up interest published in wise GEEK (2003 - 2013). The return on invested capital is the amount of money investors earn against the investment; it is a good tool to measure whether an investment is good or bad. The return on invested capital is a functional determines to conclude whether an investment is fair or not. If one investment has a superior rate of return on investment than others, the firm with the higher rate of return is the better investment, assuming risk and other variables. Better understanding of objectives of investors, individuals and investors can be explained via the term of risk. Nikiforos K Laopodis, (2013) provided Risk is the probability that there might be an unfavorable fluctuation in the rate of return distinct from expected return due to uncertainty of expected cash flows of the asset. In a market driven economy many companies make money and some firms destroy it. There are economic factors that lead to money creation or destruction or effects on the stock exchange and external factors is important to many constituencies like investment managers and corporate officials (Grant, 2003).

There are 5 basic rules are described in 'The Five Rules for Successful Stock Investing: Morningstar's Guide to building wealth and winning in the market' by Pat Dorsey' (2004) followed:

- Successful investing depends on personal discipline, not on crowd's opinion. That is why it is necessary for firms to have a solid investment philosophy.
- Unless a business is understood from outside and inside, its stocks must not be bought. It helps investor avoiding big mistakes leading to losses.
- Identify the sources of companies’ economic moats that will help to identify why a company keeps competitors at bay and consistently generates profits.

- Don't buy stocks without a margin of safety; also the cost of frequent trading can be a huge drag on performance over time.
- Know when to sell, not because of the prices increased but keeping the fundamentals in mind.

Beside the literature review, there are a number of other research journals and reports that have conducted empirical researches on determining financial ratios, investment and stock return relationship, some of the journals across the world are bought into the discussion.

1. Capital investment and stock returns.

'*Capital Investments and Stock Returns*' by '*Sheridan Titman, K. C. John Wei, and Feixue Xie'* (2004), this article reflects the results of empirical studies conducted for the following objectives:

- Determine the relation between irregular capital investments and consequent stock returns.
- If negative relation found, separating firms into distinct groups based on their investment discretion as considered by cash flow or leverage, then inspect whether the magnitude of the negative relation is substantially diverse between two groups.
- Analyze the contrarian effect (long-term return reversal) or the consequence of new equity providing contributes to the negative relation in 1st objective.

By consider all stocks listed on NYSE, Amex, NASDAQ; U.S. One month Treasury bill charges are used as risk-free rates, CRSP: stock returns, stock prices, and number of shares outstanding, COMPUSTAT: Financial statement statistics. Sample period considered was Financial data from 1969 to 1995 and Stock returns from Jul 1973 to Jun 1996 and sample size was on average of 1,635 firms a year. Three different approaches are used in this study for evaluating the returns of the various investment strategies; Characteristic-Based Benchmark Portfolios, the Carhart Four-Factor Model and Excess Returns surrounding Earnings Announcements. Empirical studies determine that firms that increase their level of capital investment are more intended to achieve lower stock returns for the five following years. This study determines the consistency of the hypothesis that investors are inclined to undervalue the significance of the unfavorable information about managerial objectives. The negative relation is

self-determining of the previously recognized long-term return reversal and less important equity issue anomalies.

2. Financial Ratios and stock returns

‘*Financial Ratios and Stock Return Predictability (Evidence from Pakistan)*’ by ‘*Muhammad Bilal Khan,* (2012)’ , this research focused on investigating the ability of dividend yield (DY) ,earning yield (EY), and book to market (B/M) ratio to predict stock returns. In the stock market, share prices keep moving every day, such random behavior worried some of the financial experts followed by some research provided by Ali K Ozdagli, (2009). Theses random movement of share prices leads to a Random walk hypothesis which provides that it is difficult to predict share prices because of varying upward and downward trend therefore it is almost impossible to predict stock return 100% accurate. In order to check the predictability power of earning yield, dividend yield and book to market ratios for predicting stock returns , this research has taken a sample of 100 firms listed in Karachi Stock Exchange for a period of 2005-2011. This study is based on secondary data, that is gathered from, “State Bank of Pakistan”, company’s annual reports, business recorder newspaper and from “Karachi stock exchange”. This study includes stock returns as dependent variable while dividend yield, earning yield and B/M ratios has been taken as independent variables. The analysis determined that financial ratios have important power of predictability for forecasting returns of stock and they forecast future stock return of Pakistani market, while book to market ratio has higher predictive power as comparable to other ratios. Similarly the certainty of stock return is improved by the combination of financial ratios.

3. External financing and stock returns

Another report is referred in this research *'External Financing and Future Stock Returns*' by *'Scott A. Richardson & Richard G. Sloan,* (2003)*’* provides the strong relationship between a measure of net external financing and future stock returns. The research found no confirmation on reactions varies systematically as a function of the category of the refinancing matter and no evidence also found on the present relationship with refinancing transactions. Findings showed that the relation vary systematically as a role of the use of the income, with a significant negative relationship existing when the proceeds are invested in net operating assets as opposed to being stored as cash or immediately charged against income. It also

determined that both externally and internally financed increases in net operating assets are negatively related to future stock returns. Nevertheless, the negative relation is rather stronger when the increase in net operating assets is on the outside as opposed to internally financed, so the misevaluation exploitation clarification may be present as a second order effect. It also indicated that the significance of concurrently investigating all financing categories in studies of external financing. Firms regularly take on in refinancing transactions that can lead to imperative absent variables in studies that consider one financing category in segregation. This particular study concluded strong and pervasive evidence of capital market inefficiency.

4. Earnings and stock returns

'The Relationship between Earnings and Stock Returns: Empirical Evidence from the Greek Capital Market' by *Panagiotis E. Dimitropouloz* (2009)*, this study* determined the relationship between earnings figured and stock returns in the context of the Greek capital market that are different compared to US, UK and other Western countries while similar to France, Italy, the Baltic region. Analysis were made on the basis of the association between stock returns and earnings in the context of the Hellenic capital market, using four model provision, the price, return, differences and deflated models. Data on published earnings and stock prices of 105 companies (all listed in the A.S.E.) for 11 years (1994-2004) were extracted from the Athens Stock Exchange database. Empirical studies evidences the high value relevancy in the Hellenic capital market expressed by the large increase of the ERC and R2 of the price and return models after controlling for the two biases mentioned above. Thus controlling for value irrelevant events and by increasing the variables measurement window we achieve to improve the low association of earnings and returns which was documented by many studies in the past.

5. Options growth and stock returns

Some empirical evidences are also found on capital investment, growth options and security returns by *Christopher W. Anderson and Luis Garcia-Feijóo* (2003). Empirical investigation is made of the broad implications of recent theoretical models that link expected returns to corporate investment and related changes in valuation. It showed stock of firms classified as low book-to-market significantly accelerate capital investment and experience increases in market value prior to the classification year.

Valuation is not self-governing of recent enlargement in capital expenditures, and neither are portfolio categorization methods. However, it formed portfolios based on prior investment increase and find that average returns are considerably inferior for portfolios collected of firms that have recently hasten investment spending. In general, the evidence is consistent with recent models and balance existing explanation of book-to-market and size as firm-specific individuality related to risk. In distinction, value stocks' average returns on capital reduce proceeding to portfolio structure and so these firms bond investment in anticipation of earnings return to equilibrium levels.

3. Conclusion

Return in investment is not necessarily same as profit; there are many ways that influence on company's decision to invest in stocks highlighted by Entrepreneur Media, Inc (2013). Number of research journals and academic literature in this research showed the relationship between capital investment and consecutive stock return, external financing and future stock returns and the relationship between earning and stock return.

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