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How To Find Winning Global Stocks

By: Jim Helik

For those **investors** with a bottom-up, stock-picking approach to **investing**, the academic literature is filled with examples of what are generally referred to as "market anomalies," in the sense that they are inconsistencies to the efficient market hypothesis. For example, when examined over longer periods, small cap stocks tend to outperform large cap stocks. Value stocks (with high book to market, earnings to price, and cash flow to price) tend to outperform growth stocks (those stocks with low book to market, earnings to price, and cash flow to price). There is also a strong element of momentum in stock returns, as stocks with a high return over the past period of less than one year, tend to outperform stocks with a poor past price performance.

Of course, index **investors** have their own explanations for all of this. The outperformance measurement of small cap stocks could simply be due to other factors such as riskiness (since small cap stocks are seen as riskier than large cap stocks). Or any of these results could be simple examples of data mining. Examine any time series of data over a long enough period and you are sure to find numerous patterns or trends.

Additional Evidence

Adding in the experience of international stock markets can help to resolve this dilemma. If these size, value, and momentum anomalies still exist in international stock markets, markets that are otherwise weakly correlated with the overall U.S. market, this can be considered to be additional evidence that there is something to these market anomalies.

Kewei Hou and Andrew Karolyi, of Ohio State University, along with Bong Kho, of Seoul National University, take a stab at this global view in a paper titled 'What Factors Drive Global Stock Returns?' They examined 26,000 stocks from 49 countries over the 1981 to 2003 period to see whether the size, value, and momentum effects exist in global stocks.

They found that the market size anomaly did not hold. However, the outperformance of value stocks (low book to market and low cash flow to price) as well as momentum (based on the past period of performance) did hold. This performance was stronger in developed countries (such as Canada, the UK, Japan, and France) than in emerging markets (such as China, South Korea, Taiwan, and Malaysia). It was also stronger in the more recent decade (1993 to 2003) than in the early 1980s.

Measuring Returns

It is important to note that the study is not a test of the importance of the market factor, either globally or locally, for measuring returns. Market direction matters to overall stock returns and can matter a lot. However, there appears to be more to returns than just this Beta. When the authors produce a multifactor model combining high cash flow to price, momentum, and a global market factor, they found that these three factors explain much of the variation in global stock market returns.

So aside from the overall market dimension, it is surprising that just two 'extra market' factors (cash flow to price and momentum) have a strong and rigorous influence in global stock market returns, even when tested against various time periods, country, and industry factors.

Momentum is important across various countries and industries, and at the firm-level as well as the industry level. Whether this persistence is due to some underlying behavioural finance conditions (picking the winners and shunning the losers) or due to some fundamentals in the stocks themselves that is not fully accounted for, is open to debate. Similarly, the importance of value as reflected in cash flow to price, as opposed to book value to price, may reflect a closer prediction of future earnings, rather than book value which reflects an accumulation of earnings from the past.

Other Predictors

The authors are quick to point out that there may be other stock market predictors out there that might be of equal or greater value, including those at the specific stock level (such as liquidity) as well as macro-economic factors which have shown themselves to be especially important in emerging markets. We can't say definitively that we understand the workings of the markets in 49 different countries, but this research is certainly a good start.

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