Equities

# Predicting Stock Returns Using Industry-Relative Firm Characteristics

February 24, 2000

*Working Paper*

Metrics such as book-to-equity, cash flow-to-price and various past return measures may be useful in forecasting future returns on equities. This paper, based on data on all NYSE, AMEX and NASDAQ stocks from June 1963 to November 1998, finds that those metrics can be more useful when they are considered in relation to the broader universe of stocks.

There are two components to this comparison: a firm's performance relative to that of similar companies (within-industry variables), and how the firm's industry compares with other industries (across-industry variables).

We find a significant within-industry momentum effect. In particular, our decomposition of one month past return strategies into within- and across-industry effects brings greater understanding to the intermediate term momentum anomaly. These effects are significant and of opposite sign at short horizons, where we find significant contrarian within-industry and momentum across-industry effects (with contrarian within-industry strategies being driven largely by the bid-ask spread), and significant and of the same sign at intermediate horizons.

For practitioners who employ quantitative stock selection models, our results suggest another, possibly better way of sorting stocks.

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