



Research Seminar Series

Thursday, November 20 2008

Time: 16:00 – 18:00, Room 013

Seminar Title

“Forecasting Stock Market Returns: The Sum of the Parts is More than the Whole”

Professor Pedro Santa-Clara

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Summary

We propose forecasting separately the three components of stock market returns: dividend yield, earnings growth, and price-earnings ratio growth. We obtain out of-sample R-squared coefficients (relative to the historical mean) of nearly 1.6% with monthly data and 16.9% with yearly data using the most common predictors suggested in the literature. This compares with typically negative R-squared coefficients obtained in a similar experiment by Goyal and Welch (2008). An investor who timed the market with our approach would have had a certainty equivalent gain of as much as 2.3% per year and a Sharpe ratio 82% higher than using the historical mean to forecast returns. We conclude that there is substantial predictability in equity returns and that it would have been possible to time the market in real time.

Pedro Santa-Clara holds the Millennium Chair in Finance at Universidade Nova de Lisboa since 2007. He is on leave as Professor of Finance at UCLA’s Anderson School of Management, where he has been since 1996. He received a Ph.D. degree in Management from INSEAD, France. He is a research associate of the National Bureau of Economic Research and serves as associate editor of the Journal of Financial and Quantitative Analysis, Journal of Business and Economic Statistics, and Management Science. Professor Santa-Clara’s research interests are focused on theoretical models of asset pricing and the development of econometric methods to estimate them. His current work focuses on quantitative portfolio management, option pricing, risk management, currency and fixed income markets, and financial econometrics.