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Using Economic Value Added as a Portfolio Separation Criterion

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This paper explores whether economic value added (EVA) can be used to generate two portfolios with statistically different cumulative returns. The analysis is done using a portfolio separation test that examines the statistical significance of the regression coefficient generated when the cumulative returns from one portfolio are regressed against the cumulative returns from the other portfolio. We conclude EVA does provide economically useful information that can be used to forecast portfolio separation. Specifically, forming portfolios based on higher and lower values of EVA divided by the average book value of debt and equity from a buy list yields portfolios with cumulative returns that are statistically different.

Introduction

Given a particular buy list of stocks, it would be useful to ascertain if one portfolio formed as a subset of the buy list should be expected to outperform another subset portfolio. In other words, is there an economic, financial, or accounting criterion that will allow the buy list to be separated into well-performing versus poorly performing portfolios? Following Cary et al. (2004), we call the process of differentiating between portfolios that are expected to perform well from a buy list and portfolios that are expected to perform poorly from the same list a portfolio separation test.

The difficulty, of course, lies in finding an economic, financial, or accounting criterion that results in successful portfolio separation. De Bondt and Thaler (1987)

Abstract

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